

Information on the international aspects of cash accounts, nostro accounts, foreign collections, investments, and borrowed funds has been incorporated into the applicable domestic sections:

- For foreign-currency cash accounts, see section 2000, "Cash Accounts."
- For due from foreign banks—demand (nostro accounts) and foreign collections (cash letters, return items), see section 2010, "Due from Banks."

- For foreign investments, see section 2020, "Acquisition and Management of Nontrading Securities and Derivative Products."
- For international borrowed funds, see section 3010, "Borrowed Funds."

Additional information on international activities can be found in the *Bank Holding Company Supervision Manual*, *Merchant and Investment Bank Examination Manual*, *Trading Activities Manual*, *Bank Secrecy Act Manual*, *Trust Activities Manual*, and *Electronic Data Processing Manual*.

Generally, the basic procedures used for the examination and verification of international operations are the same as those used for other domestic bank functions. There are, however, some modifications for different types of bank assets and liabilities and contingent accounts, as well as for the separate laws and regulations that may be applicable. Documentation and accounting procedures for international operations may also differ from those used in the domestic banking areas; however, the same examination objectives apply. The examination process may also include a review of international banking facilities (IBFs) and periodic visitations to selected foreign branches and subsidiaries to determine the safety and soundness of their operations and the adequacy of reporting procedures used by the head office or parent bank to monitor the foreign office.¹

The increasingly global nature of economic activities has made international banking operations more important to bank customers, importers and exporters of goods and services, and domestic customers with overseas operations who require a source of international financial assistance. As service institutions, commercial banks provide this assistance through global networks of representative offices, branches, and affiliates, as well as through correspondent relationships. These foreign networks also allow banks to offer services outside their traditional market areas. Additionally, in 1981, the Board of Governors amended regulations to allow for the establishment of IBFs in the United States. The activities of these facilities are limited to accepting deposits from and extending credit to foreign residents (including banks), other IBFs, and the institution establishing the IBF.

Many domestic banking activities also are conducted internationally, including providing cash and collection services, placing and taking deposits, making investments, granting loans and overdrafts, and borrowing. The international examiner will use the appropriate examination procedures for domestic operations when reviewing these activities. The examination procedures for the international aspects of these and other

activities are covered in the following international sections.

Similarly, other activities that are primarily international are similar to activities found in the domestic banking area. For example, a confirmed letter of credit represents a formal commitment to extend credit provided that certain collateral and documentary conditions exist. Foreign-exchange trading activities are similar to money-trading operations conducted at domestic funding desks. Foreign-exchange positions are similar to commodity inventories carried at book value that are exposed to fluctuating market prices. Separate international sections in this manual relate to these functions.

IBF activities are to be reviewed during the examination of international operations. The review of assets, internal controls, and operating procedures should be conducted using procedures similar to those used for offshore shell branches. In addition, reports required to be filed by IBFs should be reviewed to ensure that they are prepared properly and filed in a timely manner. A suggested questionnaire for use in examinations of IBFs is found in the appendix.

Additional international banking activities, such as direct lease financing, installment loans, real estate loans, real estate construction loans, ownership of bank premises and equipment, and other real estate owned are to be examined using the applicable procedures in section 2210, "Other Assets and Liabilities," and section 3020, "Assessment of Capital Adequacy." International examinations will also require reference to other sections of this manual. Guidelines for using these sections in international examinations are presented below under the title of each section.

WORKPAPERS

Workpapers should consist of written documentation of the examination procedures followed and the conclusions reached during the examination of international operations. The definition, purpose, quality standards, preparation, and organization of workpapers used in international examinations are the same as those discussed in section 1030, "Workpapers."

1. Separate specialized examination manuals, such as the *Merchant and Investment Bank Examination Manual*, *Trading Activities Manual*, and *Section 20 Manual*, are available to assist examiners in the examination of these foreign offices.

EXAMINATION STRATEGY

Careful planning and control are as important in international examinations as they are in domestic examinations. In this regard, a number of the procedures found in section 1000, “Examination Strategy,” also apply to international examinations, including procedures related to pre-examination analysis and review, the survey of services provided, the assignment and supervision of assisting examiners, the examination of branches, and examination review. Consequently, the assigned examiner should use the same examination procedures and internal control questionnaire, where applicable.

When assigning work in the various examination areas, the examiner should consider the organization of the bank. For example, many banks have consolidated their foreign-exchange trading and money market operations into a single division that is responsible for the bank’s global money market operations. Similar situations may be encountered where other international-related functions are combined with domestic operations. Consequently, the examination assignments should address those situations.

In some examinations, the examiner may come across certain activities that are not addressed by any particular section of the international portion of this manual. In these instances, the examiner should extract the appropriate objectives, examination procedures, and internal control questionnaires from the domestic sections of this manual.

The examiner must be certain that all types of individual customer liabilities have been analyzed on a consolidated basis, regardless of the office where they are booked. However, since the procedures for the collection and consolidation of customer liabilities booked in overseas offices differ among banks, the examiner should determine whether the bank’s procedures are adequate.

INTERNAL CONTROL

The examiner should use section 1010, “Internal Control,” in the domestic portion of this manual to evaluate the objectives of and the work performed by internal and external auditors for the bank’s international operations. The internal control section sets forth general criteria

to be considered in evaluating the work of internal and external auditors.

EXAMINATION PLANNING

Examiners assigned to review the international activities of the bank should work closely with commercial examiners, especially in those areas where international and domestic activities have a direct relationship. This cooperation includes the pre-examination analysis of the bank and is intended to determine potential problem areas and provide for adequate staffing.

COMPUTER SERVICES

During an examination that covers electronic data processing (EDP) services, provided either in-house or externally, the examiner should review the contents of the EDP report of examination to determine which sections may be applicable to international operations. An EDP examiner will generally perform the procedures contained in this section and should be consulted on matters applicable to international operations.

ASSET AND LIABILITY MANAGEMENT

Asset and liability management and interest-rate risk management sections of the manual are completed by domestic examiners for the entire bank, based, in part, on information prepared by examiners assigned to various international banking activities. Whether applicable segments of these sections will be completed during overseas examinations depends on the type of overseas examination conducted.

BANK-RELATED ORGANIZATIONS

The domestic examiner assigned this section obtains and circulates lists and information to the international examiner concerning bank-related organizations involved in international activities. Besides determining the legality of

the relationships, the international examiner should verify the accuracy and completeness of the information obtained.

REVIEW OF REGULATORY REPORTS

The domestic examiner assigned this section circulates the bank-prepared regulatory reports applicable to international operations. The international examiner will prepare any necessary comments on the appropriate report format and discuss them with bank management.

LITIGATIONS AND OTHER LEGAL MATTERS; EXAMINATION-RELATED SUBSEQUENT EVENTS

The international examiner should request from bank management a list of pending or threatened litigation and subsequent events applicable to international operations of the bank. Comments in the report should be limited to events or transactions that could materially affect the soundness of the bank.

MANAGEMENT ASSESSMENT

The overall evaluation of the management of international operations should be made by the examiner assigned to review international operations who is in a position to identify the strengths and weaknesses of the management team. An appraisal of local management should also be made during on-site examinations of foreign branches and subsidiaries.

OVERALL CONCLUSIONS REGARDING CONDITION OF THE BANK

This section is typically the responsibility of the domestic examiner-in-charge. However, the examiner assigned to review international operations must use judgment in deciding which steps in this section should be omitted. For example, certain examination procedures relating to earnings, liquidity, and ownership apply to the entire bank and not to the international area alone. However, international examiners should assist domestic examiners in developing report comments when international activities have a significant impact on the analysis of these areas.

Acceptance. A time draft (bill of exchange or usance draft) drawn by one party and acknowledged by a second party. The drawee, known as the “acceptor,” stamps or writes the word “accepted” on the face of the draft and, above his or her signature, the place and date of payment. Once the draft is accepted, it carries an unconditional obligation on the part of the acceptor to pay the drawer the amount of the draft on the date specified. A “bank acceptance” is a draft drawn on and accepted by a bank. A “trade acceptance” is a draft drawn by the seller of goods on the buyer and accepted by the buyer. See also *Banker’s acceptance*.

Account-account dealing. Foreign-exchange dealing that involves settlement from bank to bank in the due from accounts. No third party (bank) is involved.

Account party. The party, usually the buyer, who instructs the bank to open a letter of credit and on whose behalf the bank agrees to make payment.

Ad valorem. A term meaning “according to value,” used for assessing customs duties that are fixed as a percentage of the value stated on an invoice.

Advance. (1) A drawing or payout of funds representing the disbursement of a loan, including disbursement in stages. (2) In international banking, an extension of credit usually recurring, when no instrument (other than a copy of the advice of an advance) is used as evidence of a specified indebtedness, except in special cases. A signed agreement must be on file in the department, stating the conditions applicable to payments made to the borrower. The loan category does not include commercial account overdrafts but may be created to finance payments affected under a commercial letter of credit, to finance payments of collections, or to refinance a maturing loan.

Advance against documents. An advance made on the security of the documents covering a shipment.

Advised letter of credit. See *Letter of credit*.

Advised line. An authorization for credit that will be made known to the customer. See also *Guidance line*.

Affiliate. With regard to a member bank, any company (including corporate or other forms of a business entity) of which a member bank is a subsidiary or any other subsidiary of that company.

After sight. When a draft bears this name, the time to maturity begins at its presentation or acceptance.

Agent bank. The bank that leads and documents a syndicated loan.

Aggregate limit. The total volume of unliquidated foreign-exchange contracts allowed to be outstanding at any one time.

Agreement corporation. A company chartered or incorporated under state law that, like an Edge Act corporation, is principally engaged in international banking. See also *Edge Act*.

Allocated transfer risk reserve (ATRR). Reserves against certain country risk exposures required by the International Lending Supervision Act of 1983.

Amortizing swap. A transaction in which the notional value of the agreement declines over time.

Appreciation. A rise in the value of a currency relative to the market of another currency.

Arbitrage. Simultaneous buying and selling of foreign currencies, securities, or commodities to realize profits from discrepancies between exchange rates prevailing at the same time in different markets, between forward margins for different maturities, or between interest rates prevailing at the same time in different markets or currencies.

Asian currency unit. A foreign-exchange trading department of a bank located in Singapore that has received a license from the monetary authority in that country to deal in external currencies.

Asked price. The price sought by any prospective seller of an asset or the price at which a market-maker of an asset will sell.

Assignment. The transfer in writing by one person to another of title to personal property. In banking, one bank may assign another the right to receive loan principal and interest from a borrower. The assignment of stocks or registered bonds may be effected by filling in the form printed on the reverse of the certificate.

Association of International Bond Dealers (AIBD). A private association founded in Zurich, Switzerland, in 1969 to establish uniform issuing and trading procedures in the international bond markets.

At sight. A term indicating that a negotiable instrument is payable upon presentation or demand.

At the money. A term used to refer to a call or put option whose strike price is equal (or virtually equal) to the current price of the asset on which the option is written.

Authority to pay. An advice from a buyer, sent by his or her bank to the seller's bank, authorizing the seller's bank to pay the seller's (exporter's) drafts up to a fixed amount. The seller has no protection against cancellation or modification of the instrument until the issuing bank pays the drafts drawn on it, in which case the seller is no longer liable to its bank. These instruments are usually not confirmed by the seller's American bank.

Authority to purchase. Similar to an authority to pay except that under this arrangement drafts are drawn directly on the buyer. The correspondent bank purchases them with or without recourse against the drawer and, as in the case of the authority to pay, they are usually not confirmed by an American bank. This type of transaction is unique to Far Eastern trade.

Baker Plan. Proposed in 1985, this initiative encouraged banks, the International Monetary Fund, and the World Bank to jointly increase lending to less-developed countries (LDCs) that were having difficulty servicing their debt, provided these countries undertook prudent measures to increase productive growth.

Balance of payments. A term indicating a nation's external cash flow (to other countries, whether positive or negative) for a given period of time, including trade, current financial, and capital inflows and outflows.

Balance of trade. The difference between a country's total imports and total exports for a given period of time. A "favorable" balance of trade exists when exports exceed imports.

Band. The maximum range that a currency may fluctuate from its parity with another currency or group of currencies by official agreement.

Bank for International Settlements (BIS). Established in 1930 in Basle, Switzerland, the BIS is the oldest functioning international financial organization. It provides a forum for frequent consultation among central bankers on a wide range of issues.

Banker's acceptance. A time draft that has been drawn on and accepted by a bank. The bank accepting the time bill becomes primarily liable for payment. See also *Acceptance*.

Banker's acceptance liability. The moment the draft is accepted by the bank, a direct liability is recorded in its "Acceptances Executed" account. The contra account on the

asset side of the balance sheet is "Customer's Liability on Acceptances." On the date of maturity of the banker's acceptance, the bank charges the customer's account and retires the acceptance by paying the beneficiary or drawee of the draft. The bank's liability records at this point are liquidated, and the transaction is completed.

Barter. Exchange of commodities using merchandise as consideration instead of money. This scheme has been employed in recent years by countries that have blocked currencies.

Base rate. A rate used as the basis or foundation for determining the current interest rate to be charged to a borrower, such as the prime rate or London Interbank Offered Rate (LIBOR).

Basle Capital Accord. An agreement among the central banks of leading industrialized countries, including those of Western Europe, Canada, the United States, and Japan, to impose common capital requirements on their internationally active banks to take into account bank risk exposure.

Basis. The cash or spot price minus the futures price.

Basis risk. The risk associated with nonparallel movement of interest rates. Banks face exposure in two situations. The first occurs when an operator uses, for example, a Treasury bill to hedge an interest-rate risk in Eurodollars. The interest rates for T-bills and Eurodollars do not always move exactly parallel to each other. The risk of this lack of parallel movement is basis risk. The second occurs when the period of time for which a financial risk exists is not identical with the period of time for which the hedge is arranged, for example, when a three-month interest risk in a revolving Eurodollar loan is hedged with a six-month futures contract in Eurodollars. A change in the shape of the yield curve can bring about nonparallel movements in interest rates for the two different maturities.

Basis swap. A transaction in which one participant pays a floating rate of interest based on one index, and the other party pays a floating rate of interest based on another interest-rate index.

Beneficiary. The person or company in whose favor a letter of credit is opened or a draft is drawn.

Bid-asked spread. The difference between a bid and the asked price, for example, the difference between 0.4210 and 0.4215 would be a spread of 0.0005 or 5 points.

Bid price. A buyer's quote for the purchase of a trading unit from a prospective seller.

Bid rate. The price at which the quoting party is prepared to purchase a currency or accept a deposit. If the bid rate is accepted by the party to whom it was quoted, then that party will sell currency or place or lend money at that price. The opposite transaction takes place at the offer rate.

Bilateral trade. Commerce between two countries, usually in accordance with specific agreements on amounts of commodities to be traded during a specific period of time. Balances due are remitted directly between the two nations.

Bill of exchange. An instrument by which the drawer orders another party (the drawee) to pay a certain sum to a third party (the payee) at a definite future time. The terms "bill of exchange" and "draft" are generally interchangeable.

Bill of lading. A receipt issued by a carrier to a shipper for merchandise delivered to the carrier for transportation from one point to another. A bill of lading serves as a receipt for the goods, document of title, and contract between the carrier and the shipper covering the delivery of the merchandise to a certain point or designated person. It is issued in two primary forms: an "order bill of lading," which provides for the delivery of goods to a named person or to his or her order (designee), but only on proper endorsement and surrender of the bill of lading to the carrier or its agents, and a "straight bill of lading," which provides for delivery of the goods only to the person designated by the bill of lading.

- **Clean bill of lading.** A bill of lading in which the described merchandise has been received in "apparent good order and condition" and without qualification.
- **Ocean bill of lading.** A document signed by the captain, agents, or owners of a vessel furnishing written evidence for the conveyance and delivery of merchandise sent by sea. It is both a receipt for merchandise and a contract to deliver it as freight.
- **Order bill of lading.** A bill of lading, usually drawn to the order of the shipper, that can be negotiated like any other negotiable instrument.
- **Order "notify" bill of lading.** A bill of lading usually drawn to the order of the shipper or a bank with the additional clause that the consignee is to be notified upon arrival of the merchandise. However, the mention of the

consignee's name does not confer title to the merchandise.

- **Stale bill of lading.** A bill of lading that has not been presented under a letter of credit to the issuing bank within a reasonable time after its date, thus precluding its arrival at the port of discharge by the time the ship carrying the related shipment has arrived.
- **Straight bill of lading.** A bill of lading drawn directly to the consignee and therefore not negotiable.
- **Through bill of lading.** A bill of lading used when several carriers are used to transport merchandise, for example, from a train to a vessel or vice versa.
- **Unclean bill of lading.** A bill of lading across the face of which exceptions to the receipt of goods "in apparent good order" are noted. Examples of exceptions include burst bales, rusted goods, and smashed cases.

Black market. A private market that operates in contravention of government restrictions.

Blocked account. An account from which payments, transfers, withdrawals, or other dealings may not be made without Office of Foreign Asset Control (OFAC) or U.S. Treasury Department approval. Although the bank is prohibited from releasing funds from these accounts, deposits may be accepted. Banks are subject to significant fines for releasing funds from blocked accounts. See also *Office of Foreign Asset Control, Specially designated nationals*.

Blocked currency. A currency that is prohibited by law from being converted into another foreign currency.

Book-entry form. The method by which marketable securities are issued with the buyer receiving only a receipt rather than an engraved certificate, which indicates that the purchase is recorded on the issuer's books or recorded in another approved location.

Brady Plan. Proposed in 1989 and named after then U.S. Treasury Secretary Nicholas Brady, the Brady Plan sought to reduce the debt-service requirements of various developing countries and to provide new loans (Brady bonds) to service existing obligations.

Break-even exchange rate. The particular spot exchange rate that must prevail at the maturity of a deposit or debt in a foreign currency (which has not been covered in the forward market) so that there will be no advantage to any party from interest-rate differentials.

Bulldog bonds. British pound sterling-denominated foreign bonds issued in London.

Bullion. Unminted precious metals (gold, silver) of standard or stipulated fineness in the form of bars, ingots, or nuggets. The value of gold bullion, usually in bars, used in the settlement of international balances is determined by weight and degree of fineness.

Buyer's option contract. A contract in which the buyer has the right to settle a forward contract at any time within a specified period. See also *Option contracts*.

Buying rates. Rates at which foreign-exchange dealers will buy a foreign currency from other dealers in the market and at which potential sellers are able to sell foreign exchange to those dealers.

C & I loans. Commercial and industrial loans.

Cable. A message sent and delivered by an international record carrier via satellite or cable connections to a foreign country. "Cable" as used in the international sections also includes messages transmitted by bank telex. The terms "cable" and "telex" are generally used interchangeably.

Call money. Funds placed with a financial institution without a fixed maturity date. The money can be "called" (withdrawn) at any time by telephone. "Same day" call money means the call must (usually) be made before 10:00 a.m. In addition, "24-hour," "48-hour," and "7-day" call money means the money must be called one, two, or seven calendar days before the actual payment date. Although these are the most common varieties of call money, two parties can agree on different dates.

Call option. A contract giving the purchaser the right, but not the obligation, to buy an asset at a stated price on or before a stated date.

Capital controls. Governmental restrictions on the acquisition of foreign assets or foreign liabilities by domestic citizens or restrictions on the acquisition of domestic assets or domestic liabilities by foreign citizens.

Cedel. One of two main clearing systems in the Eurobond market, Cedel, based in Luxembourg, began operations in 1971 and recently established Cedel Bank, a clearing bank chartered in Luxembourg. See also *Euroclear*.

Central bank intervention. Direct action by a central bank to increase or decrease the supply of currency to stabilize prices in the spot or forward market or to move them in a desired direction. On occasion, the announcement of an intention to intervene might achieve the desired results.

Certificate of inspection. A document often required for shipment of perishable goods in which certification is made as to the good condition of the merchandise immediately before shipment.

Certificate of manufacture. A statement, sometimes notarized, by a producer who is usually also the seller of merchandise that manufacture has been completed and that goods are at the disposal of the buyer.

Certificate of origin. A document issued by the exporter certifying the place of origin of the merchandise to be exported. The information contained in this document is needed primarily to comply with tariff laws that may extend more favorable treatment to products of certain countries.

Chain. A method of calculating cross rates. For example, if a foreign-exchange trader knows the exchange rate for German marks against U.S. dollars and for French francs against U.S. dollars, the "chain" makes possible a calculation of the cross rates for German marks against French francs.

Charges forward. A banking term used when foreign and domestic bank commission charges, interest (if any), and government taxes in connection with the collection of a draft are for account of the drawee.

Charges here. A banking term used when foreign and domestic bank commission charges, interest (if any), and government taxes in connection with the collection of a draft are for account of the drawer.

Charter party. A contract, expressed in writing on a special form, between the owner of a vessel and the one (the charterer) desiring to employ the vessel, setting forth the terms of the arrangement, such as freight rate and ports involved in the trip contemplated.

Chicago Board of Trade (CBT). A futures exchange.

Chicago Board Options Exchange (CBOE). An options exchange in which European foreign-currency options on spot exchange are traded.

Chicago Mercantile Exchange (CME). A futures exchange.

Clean collection. A collection in which a draft or other demand for payment is presented without additional attached documentation.

Clean draft. A sight or time draft to which no other documents, such as shipping documents, bills of lading, or insurance certificates, are attached. This is to be distinguished from a documentary draft. See also *Documentary draft*.

Clean risk at liquidation. A type of credit risk that occurs when exchange contracts mature. There may be a brief interval (usually no more than a few hours) during which one of the parties to the contract has fulfilled its obligations, but the other party has not. During this period, the first party is subject to a 100 percent credit risk, on the chance that, in the interval, an event may prevent the second party from fulfilling its obligations under the contract.

Clearing corporation. A clearinghouse that exists as an independent corporation rather than as a subdivision of an exchange.

Clearinghouse. A subdivision of an exchange or an independent corporation through which all trades must be confirmed, matched, and settled daily until offset.

Clearinghouse funds. Funds used in settlement of a transaction that are available for use or that become good funds after one business day.

Clearing House Interbank Payments System (CHIPS). A computerized telecommunications network provided by the New York Clearing House Association (NYCHA), which serves as an automated clearinghouse for interbank funds transfers.

Closing a commitment. Allowing a covered foreign-exchange position to expire on maturity or reversing it before maturity by a swap operation.

Closing a position. Covering open long or short positions by means of a spot operation and/or outright forward operation.

Comanager. A bank ranking just below that of lead manager in a syndicated Eurocredit or an international bond issue. The status of comanager usually indicates a larger share in the loan or a larger bond allotment, and a larger share in the fees, than banks of lower rank. Comanagers may also assist the lead managers in assessing the market or determining terms of the loan.

Combined transport document. A through bill of lading that applies to more than one mode of transport.

Commercial paper. A short-term, unsecured debt instrument issued by a corporation and sold at a discount from its maturity value.

Commercial transaction. A transaction between a dealing bank and a nonbanking (commercial) party.

Commodities Futures Trading Commission (CFTC). A U.S. regulatory body that regulates exchange-based futures trading in the United States.

Commodity Credit Corporation (CCC). An instrument of the federal government whose principal purpose is to provide the necessary financial services to carry forward the public price-support activities, including government lending, purchasing, selling, storing, transporting, and subsidizing certain agricultural commodities.

Common carrier. An individual, partnership, or corporation, such as a shipping line, railroad, or airline, that undertakes for hire to transport persons or commodities from place to place. Governed by special laws, common carriers must accept all business offered them under their regulations.

Compromises. Occasions when both parties agree to alter the terms of an existing foreign-exchange contract. These alterations should be approved by an impartial bank officer and the operations personnel must be advised of each compromise to avoid settlement in accordance with the original terms.

Confirmation. The written communication to the counterparty in a foreign exchange, interbank deposit, or other money market transaction that recites all the relevant details agreed upon by phone or telex.

Confirmed letter of credit. See *Letter of credit*.

Consignment. The physical transfer of goods from a seller (consignor), with whom the title remains, to another legal entity (consignee), who acts as a selling agent, selling the goods and remitting the net proceeds to the consignor.

Consular documents. Bills of lading, certificates of origin, or special forms of invoice that carry the official signature of the consul of the country of destination.

Consular invoice. A detailed statement on the character of goods shipped, which is duly certified by the consul at the port of shipment. Required by certain countries, including the United States, its principal function is to accurately record the types of goods and their quantity, grade, and value for import duty and general statistical purposes.

Contract limit. A maximum limit on the total gross notional principal amount of outstanding contracts booked with one customer.

Contract risk (counterparty risk). Risk that the counterparty will default before settlement.

Convertibility. Freedom to exchange a currency, under certain circumstances, without government restrictions or controls.

Correspondent bank. A bank located in one geographic area that accepts deposits from a

bank in another region and provides services on behalf of this other bank. Internationally, many banks maintain one account with a correspondent bank in each major country to be able to make payments in all major currencies. Correspondent banks are usually established on a reciprocal basis.

Cost, insurance, and freight (C.I.F.). A price quotation under which the seller defrays all expenses involved in the delivery of goods.

Counterpart funds. Local currencies deposited in a special account by recipient governments that represent grant aid extended by another government. Those funds, while remaining the property of the recipient government, can generally be used only by agreement of the donor government.

Country exposure. A measurement of the volume of assets and off-balance-sheet items considered to be subject to the risk of a given country. This measurement is based, in part, on identifying the country of domicile of the entity ultimately responsible for the credit risk of a particular transaction.

Country limit. The amount of money that a bank has established as the maximum it is willing to lend borrowers in a given country regardless of the type of borrower or the currencies involved.

Country risk. Refers to the spectrum of risks arising from the economic, social, and political environment of a given foreign country, which could have favorable or adverse consequences for foreigners' debt and/or equity investments in that country.

Cover. The execution of an offsetting foreign-exchange trade to close or eliminate an open exposure.

Covered interest arbitrage. The process of taking advantage of a disparity between the net accessible interest differential between two currencies and the forward exchange premium or discount on the two currencies against each other.

Crawling peg system. An exchange-rate system in which the exchange rate is adjusted every few weeks, usually to reflect prevailing inflation rates.

Credit risk. The possibility that the buyer or seller of foreign exchange or some other traded instrument may be unable to meet his or her obligation on maturity.

Credit swap. A link transaction wherein one party places a deposit in one currency (probably dollars) with a foreign bank during the period

that the foreign bank lends another currency to a third party. The deposit serves as an inducement for the transaction, and its value is considered in pricing the loan.

Cross-border exposure. The risk that arises when an office of a bank, regardless of its location or currency, extends credit to a borrower that is located outside the booking unit's national border.

Cross-currency risk. The risk associated with maintaining exchange positions in two foreign currencies as the result of one transaction. For example, if a U.S. operator borrows Swiss francs at 5 percent and invests the proceeds in British pounds at 12 percent, the cross-currency risk is the chance that the pounds will depreciate in value against the Swiss francs to such an extent that there will be a loss on the transaction in spite of the favorable interest-rate differential.

Cross-default. A term used to describe a clause in a syndicated loan or bond contract that gives the lender the right to accelerate repayment of the loan if the borrower defaults on another loan.

Cross-hedging. The hedging of an asset with a futures contract of a different asset.

Cross rate. The ratio between the exchange rates of two foreign currencies in terms of a third currency.

Currency futures and options contracts. An agreement that allows businesses or individuals acquiring or selling foreign currencies to protect themselves against future fluctuations in currency prices by shifting currency risk to someone willing to bear that risk.

Currency liquidity. In a multicurrency investment portfolio, the liquidity of a given foreign currency has to be viewed in terms of exchange liquidity and instrument liquidity. Exchange liquidity depends on the ease with which a currency can be converted into and out of another major currency. Instrument liquidity depends on the ease with which a negotiable instrument denominated in that currency can be purchased and sold without noticeably affecting the market rate for that instrument.

Currency swap. A contractual obligation entered into by two parties to deliver a sum of money in one currency against a sum of money in another currency at stated intervals (or a stated interval) or according to negotiated terms. See *Swap*.

Current account. Those items in the balance of payments involving imports and exports of goods and services as well as unilateral transfers.

Customs union. An agreement between two or more countries in which they arrange to abolish tariffs and other import restrictions on each other's goods and to establish a common tariff for the imports of all other countries.

Date draft. A draft drawn to mature on a fixed date, regardless of its acceptance.

Daylight limit. The maximum net foreign-exchange position that a bank will allow during business hours.

Dealer (or trader). A person who executes foreign-exchange, interbank deposit, or other money market trades for a dealing bank.

Debt for equity swaps. Debt (usually LDC government debt) that is discounted and exchanged for equity in local businesses (often newly privatized).

Debt swaps. The exchange of LDC loans based on the prices quoted in the secondary market. Swaps are often used to decrease exposure to certain countries.

Default risk. The risk to the holder of debt securities that a borrower will not meet all promised payments at the times agreed upon.

Del credere agent. A sales agent who, for a certain percentage above his or her sales commission, guarantees payment to the person for whom he or she is selling on shipments made to the seller's customers.

Delivery. The offset of an obligation to buy or sell an asset by an actual transfer of title to the asset at a prearranged price. In the futures market, the transfer or receipt of a cash instrument against a short or long futures contract.

Delivery order. An order addressed to the holder of goods and issued by anyone who has authority to do so, that is, by one who has the legal right to order delivery of merchandise. A delivery order is not considered a good titled document.

Delivery risk. The possibility that a seller of foreign exchange, having collected the payment in local currency, may fail to deliver the exchange in the foreign center where it was sold. Also called settlement risk.

Delta of an option. The rate of change of the value of an option with respect to the price of the underlying asset, reference rate, or index evaluated at the current market price of that underlier.

Demand draft. A draft that is payable immediately upon presentation to the drawee. This type of draft is also termed a "sight" or "presentation" draft.

Deposit dealer. A term used in the United States for bank personnel responsible for lending and borrowing funds in the interbank market.

Deposit trader. A term used in Europe for bank personnel responsible for lending and borrowing funds in the interbank market.

Depreciation. A drop in the value of a currency relative to the value of another currency.

Depth of the market. The amount of currency that can be traded in the market at a given time without causing a price fluctuation. Thin markets are usually characterized by wide spreads and substantial price fluctuations during a short period of time. Strong markets tend to be characterized by relatively narrow spreads of stable prices.

Derivative instrument. An instrument that is based on or derived from the value of an underlying asset, reference rate, or index. For example, interest-rate futures are based on various types of securities trading in the cash market. Some interest-rate options are derived from interest-rate futures.

Devaluation. An official act wherein the official parity of a country's currency is adjusted downward to the dollar, gold, Special Drawing Rights (SDRs), or another currency. After a devaluation, there are more devalued currency units relative to the dollar, gold, SDRs, or other currency. See also *Revaluation*.

Development bank. A lending agency that provides assistance to encourage economic development.

Direct quote. The method of quoting fixed units of foreign exchange in variable numbers of the local currency unit. Also called a "fixed" or "certain" quotation.

Dirty float (or Managed float). A floating exchange-rate system in which some government intervention still takes place. A government may announce that it will let its currency float, that is, it will let the currency's value be determined by the forces of supply and demand in the market. The government, however, may secretly allow its central bank to intervene in the exchange market to avoid too much appreciation or depreciation of the currency.

Discount.

- *Lending*—To subtract from a loan, when it is first made, the amount of interest that will be due when it is repaid.
- *Foreign exchange*—The amount by which the forward exchange rate of one currency against another currency is less than the spot exchange rate between the two currencies.

- *Financial*—A deduction from the face value of commercial paper, such as bills of exchange and acceptances, in consideration of cash the seller has received before the maturity date. The rates of discount vary according to the state of the given money market, the financial standing of the persons involved, and other circumstances surrounding the transaction.

- *Commercial*—An allowance from the quoted price of goods, usually made by the deduction of a certain percentage from the invoice price.

Discount rate. Most commonly the rate at which a Federal Reserve Bank (or, in many instances, foreign central banks) is prepared to lend to financial institutions against eligible collateral.

Dishonor. Refusal on the part of the drawee to accept a draft or to pay it when due.

Divergence indicator system. One aspect of the European Monetary System that measures the departure of a country's economic policies from the European Union's "average." The measure of divergence is based exclusively on the movement of a country's exchange rate with respect to the European Currency Unit (ECU).

Dock receipt. A receipt issued by an ocean carrier or its agent for merchandise delivered at its dock or warehouse that is awaiting shipment.

Documentary collection. A collection in which a draft is accompanied by shipping or other documents.

Documentary credit. A commercial letter of credit providing for payment by a bank to the named beneficiary, who is usually the seller of merchandise, against delivery of documents specified in the credit.

Documentary draft. A draft to which documents are attached, that is delivered to the drawee upon acceptance or payment of the draft and that ordinarily controls title to the merchandise.

Documents. The shipping and other papers customarily attached to foreign drafts, consisting of ocean bills of lading, marine insurance certificates, and commercial invoices. Certificates of origin and consular invoices may also be required.

Documents against acceptance (D/A). Instructions given by an exporter to a bank that the documents attached to a draft for collection are deliverable to the drawee only against his or her acceptance of the draft.

Documents against payment (D/P). Instructions given by an exporter to his or her bank that

the documents attached to a draft for collection are deliverable to the drawee only against his or her payment of the draft.

Domestic bond. A domestic debt security sold by an issuer in its own country and denominated in that country's currency.

Domicile. The place where a draft or acceptance is made payable.

Draft. An order in writing signed by one party (the drawer) requesting a second party (the drawee) to make payment at a determinable future time to a third party (the payee). It may be accompanied by a bill of lading, which the bank will surrender to the buyer upon payment of the draft. The buyer may then claim the goods at the office of the carrier who transported them to the buyer's place of business. See also *Sight draft* or *Time draft*.

Dragon bond. A bond issued by a foreign borrower in an Asian or Pacific country (excluding Japan—see *Samurai bond*).

Drawee. The addressee of a draft, that is, the person on whom the draft is drawn.

Drawer. The issuer or signer of a draft.

Duration. A time-weighted present-value measure of the cash flow of a loan or security that takes into account the amount and timing of all promised interest and principal payments associated with that loan or security.

Duty. (1) Ad valorem duty (according to the value) is an assessment at a certain percentage rate on the actual value of an article. (2) Specific duty is an assessment on the weight or quantity of an article without reference to its monetary value or market price. (3) Drawback is a recovery in whole or in part of duty paid on imported merchandise at the time of reexportation, whether in the same or different form.

Edge Act. Incorporated as section 25A of the Federal Reserve Act, this act authorizes the Board of Governors to charter corporations (Edge corporations) for the purpose of engaging in international or foreign banking or in other international operations.

Eligible acceptance. A banker's acceptance that meets Federal Reserve requirements related to its financing purpose and term.

Eligible value date. A normal business day on which a payment to settle a money market transaction can be made. An eligible value date for a foreign-exchange transaction must be a business day in the home countries of both of the currencies involved.

Engineered swap transaction. A spot transaction and an offsetting forward transaction in

which each of the two transactions is carried out with a different party.

Eurobank. A bank that regularly accepts foreign currency-denominated deposits and makes foreign-currency loans.

Eurobonds. Long-term debt securities denominated in a currency other than that of the country or countries where most or all of the security is sold.

Euroclear. Euroclear Clearance System Limited is one of two main clearing systems in the Eurobond market. Euroclear, which began operations in December 1968, is located in Brussels and managed by Morgan Guaranty. See also *Cedel*.

Eurocurrency. The nonresident ownership of one of the major western European currencies. Eurocurrencies, similar to Eurodollars, are frequently available for borrowing in the London Interbank Market.

Eurocurrency market. The money market for borrowing-and-lending currencies that are held in the form of deposits in banks located outside the countries in which those currencies are issued as legal tender.

Eurodollars. Dollar deposit claims on U.S. banks that are deposited in banks located outside the United States, including foreign branches of U.S. banks. These claims, in turn, may be redeposited with banks or lent to companies, individuals, or governments outside the United States.

Eurodollar deposit rate. The interest rate at which a quoting bank is willing to take wholesale Eurodollar funds with a particular maturity from other than an interbank participant. The rate is usually one-eighth to one-sixteenth of one percent lower than LIBOR.

European Currency Unit (ECU). A portfolio currency used in the European Monetary System as a community “average” exchange rate. It is also used in the private market as a means of payment and as a currency of denomination for lending, borrowing, and trade.

European Monetary System (EMS). An arrangement introduced in March 1979 for economic and monetary cooperation among the members of the European Union. The ultimate aim of the EMS is a single European Currency and the establishment of a European central bank.

European Union (EU). Formerly the European Community, an economic association of European countries founded by the Treaty of Rome in 1957. The goals of the EU are the

removal of trade barriers among countries, the formation of a common commercial policy toward non-EU countries, and the removal of barriers restricting competition and the free mobility of factors of production. Members include Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom.

Exchange contracts. Documents issued by foreign-exchange dealers, banks dealing in foreign exchange, and foreign-exchange brokers confirming foreign-exchange transactions.

Exchange control or restrictions. Limits on free dealings in foreign exchange or of free transfers of funds into other currencies and other countries.

Exchange control risk. The possibility of defaults on obligations by imposing or reinforcing exchange control.

Exchange-rate differential. The difference between two exchange rates in a swap transaction.

Exchange rates. The price of one currency in terms of another. See also *Spot exchange*, *Buying rates*, *Fixed rate of exchange*, *Floating rate*, and *Interbank rate of exchange*.

Exchange reserves. The total amount of freely convertible foreign currencies held by a country's central bank.

Exchange risk. The possibility of a loss on an open position as a result of an appreciation or depreciation of the exchange.

Exercise. The use of the right given by an option: purchase (if a call) or sale (if a put) of an asset at the strike price stated in the option contract.

Exit bonds. Low-interest government bonds issued in LDCs that are equivalent to a portion of the country's existing bank debt. Designed to facilitate debt management.

Expiration date. The last day on which an option may be exercised.

Export credit insurance. A system to insure the collection of credits extended by exporters against various contingencies. In some countries, only noncommercial risks can be insured.

Export declaration. A document required by the U.S. government for shipments abroad and used to maintain statistics on our exports.

Export-Import Bank of the United States (Eximbank). An institution that provides intermediate and long-term nonrecourse financing for U.S. exports when these facilities are not available from commercial banks. All of the Eximbank's shares are held by the U.S. Treasury.

Export trading company (ETC). A company designed to facilitate U.S. exports. An ETC may be an affiliate of a bank holding company.

Fail. Nonperformance of an obligation on the specified day, for example, failure to make prompt settlement for either side of a foreign-exchange contract, usually due to a clerical or trader error. A fail usually leads to an interest adjustment for an overdraft in the paying or receiving bank.

FA.S. See *Free alongside ship*.

Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). This act had various aims, including the least-cost resolution of troubled insured depository institutions, improvement of bank supervision and examinations, and provision of additional resources to the Bank Insurance Fund.

Federal funds. Deposits held by commercial banks at a Federal Reserve Bank. Since reserve requirements of commercial banks are satisfied by federal funds, banks with deposits in excess of required reserves will lend the excess deposits to banks with a reserve shortage at a market-determined interest rate, called the federal-funds rate.

Federal Reserve System. The central bank of the United States, created by the Federal Reserve Act of 1913, consisting of the Board of Governors in Washington, D.C., and 12 regional Federal Reserve Banks. The Federal Reserve controls the country's monetary base and has the power to set reserve requirements, conduct open-market operations, and lend directly to banks.

Fedwire. The large-value payment mechanism owned and operated by the Federal Reserve System. Fedwire provides depository institutions with real-time settlement in the central bank of funds transfers and book-entry securities transfers made for their own account or on behalf of their customers.

Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). The purpose of this act was to reform, recapitalize, and consolidate the federal deposit insurance system and to enhance the regulatory and enforcement powers of federal financial institutions' regulatory agencies.

Fixed exchange-rate system. A system in which the exchange rate of a country's currency is tied to one major currency, such as the U.S. dollar.

Fixed rate of exchange. A rate of exchange set by a foreign government relative to the dollar, gold, another currency, or perhaps Spe-

cial Drawing Rights. It remains in effect as long as that government is willing or able to buy and sell at the set rates.

Fixed-rate payer. A position applicable to a rate swap, in which the fixed payer pays the fixed rate and receives the floating rate.

Flexible rate of exchange. A rate of exchange subject to relatively frequent changes. It is determined by market forces but subject to various floors or ceilings relative to the dollar, gold, Special Drawing Rights, or another currency when the rate fluctuates beyond certain parameters.

Floating exchange-rate system. A system in which the values of the currencies of various countries relative to each other are established by supply and demand forces in the market without government intervention.

Floating rate. A rate of exchange that is determined completely by market forces with no floor or ceiling vis-a-vis the dollar, gold, Special Drawing Rights, or another currency.

Floating-rate notes. Bonds that pay interest at an agreed margin above a market reference rate. The interest rate varies according to variations in the market reference rate.

Floating-rate payer. A position applicable to a rate swap, in which the floating payer pays the floating rate and receives the fixed rate.

F.O.B. See *Free on board (destination or vessel)*.

Foreign Bank Supervision Enhancement Act (FBSEA). Part of the FDIC Improvement Act of 1991, FBSEA expanded the supervisory authority of the Federal Reserve over the U.S. operations of foreign banks.

Foreign bonds. Bonds issued by nonresidents but underwritten primarily by banks registered in the country where the issue is made.

Foreign Credit Insurance Association (FCIA). An insurance company established under the auspices of Eximbank. Insurers trade credits granted by U.S. suppliers of products to purchasers abroad who qualify as normal risks. The insurance protects the exporter, up to an agreed percentage, against any nonpayment resulting from commercial or political risks, or both. Eximbank provides reinsurance for the entire portion of the commercial credit risk and is the sole insurer of the political risk.

Foreign currency. The currency of any foreign country that is the authorized medium of circulation and the basis for recordkeeping in that country. Foreign currency is traded by banks either by the actual handling of currency

and checks or by the establishment of balances in foreign currencies with banks in those countries.

Foreign deposits. Those deposits that are payable at a financial institution outside the jurisdiction of the U.S. government and in the currency of the country in which the depository is located. See also *Nostro account*.

Foreign draft. An official bank order drawn on a foreign correspondent bank to pay on demand to a designated payee a specific sum of foreign money or U.S. dollars at the drawee's buying rate.

Foreign exchange. The trading or exchange of a foreign currency in relation to another currency.

Foreign-exchange futures contracts. Standardized contracts traded on an organized futures exchange and settled through the clearinghouse of the exchange. Each contract defines the currencies, contract amounts, and delivery dates for its own contracts.

Foreign-exchange market. Communications between dealers and brokers to transact wholesale business in foreign exchange and Eurocurrencies.

Foreign-exchange rationing. A government requirement that all holders of bills of exchange relinquish them at a stipulated rate.

Foreign-exchange reserves (official). The reserves maintained by a central bank, which usually include gold and easily traded currencies of major industrial nations.

Foreign-exchange risk. The risk associated with exposure to fluctuation in spot exchange rates.

Foreign Investment Advisory Service (FIAS). Established in 1986, FIAS counsels developing countries on attracting foreign capital. FIAS operates under the aegis of the World Bank and its affiliates, the International Finance Corporation and the Multilateral Investment Guarantee Agency.

Foreign trade zone. An area where goods may be received and stored without entering a country's customs jurisdiction and without paying duty. Sometimes called a "free trade zone."

Forward book. The aggregate of all forward contracts for a given currency or all currencies.

Forward contract. A contract that obligates one party to sell and another to buy a specific asset for a specified price at a designated time.

Forward discount ("at a forward discount"). A phrase used to describe a currency whose forward price is cheaper than its spot price.

Forward exchange. Foreign currency traded for settlement beyond two working or business days from today.

Forward exchange position. The long or short position that a dealer may have in the forward market, as compared to spot dealing.

Forward exchange risk. The possibility of a loss on a covered position as a result of a change in the swap margin.

Forward-forward dealing. The simultaneous purchase and sale of a currency for different forward dates.

Forward premium ("at a forward premium"). A phrase used to describe a currency whose forward price is more expensive than its spot price.

Forward purchase. An outright purchase of a forward contract.

Forward rates. The actual rates at which foreign exchange for future delivery are quoted, bought, and sold.

Forward swap. A transaction in which the initial fixed- and floating-rate payments are deferred until a future period of time.

Forward transaction date. Value dates that are more than two business days following the trade date. Regular forward dates are 30, 60, and 90 days from the trade date.

Free alongside ship (F.A.S.). A term for a price quotation under which the seller delivers merchandise free of charge to the steamer's side and pays lighterage expenses up to that destination, if necessary.

Free on board (F.O.B.) (destination). A term for a price quotation under which the seller undertakes at his or her risk and expense to load the goods on a carrier at a specified location. Expenses subsequent thereto are for account of the buyer.

Free on board (F.O.B.) (vessel). A term for a price quotation under which the seller delivers the goods at his or her expense on board the steamer at the location named. Subsequent risks and expenses are for account of the buyer.

Free port. A foreign trade zone, open to all traders on equal terms, where merchandise may be stored duty-free pending its reexport or sale within that country.

Free trade area. An arrangement between two or more countries for free trade among themselves, although each nation maintains its own independent tariffs toward nonmember nations. It should not be confused with "free trade zone," which is synonymous with "foreign trade zone."

Fungible securities. Securities that are not individually designated by serial number as belonging to a particular owner. Instead, a clearing system or depository institution credits owners with a given number of a particular bond issue (or other security issue). The owner may have title to 50 bonds, but not to 50 specific bonds with designated serial numbers.

Futures commission merchant (FCM). A firm that is registered with the CFTC and legally authorized to solicit or accept orders from the public for the purchase or sale of futures contracts. Acts as an intermediary between a public customer and a floor broker.

Futures contract. An exchange-traded contract in which one party agrees to buy a security and another agrees to sell a security in the future. If held until maturity, the futures contract may involve accepting (if long) or delivering (if short) the asset on which the futures price is based.

Futures market. A market in which contracts are traded for future delivery of commodities, currencies, and financial instruments. The purchase or sale of a futures contract requires that a deposit, called margin, be maintained with a broker. The market is designed in such a way that it is easy to get out of a contract or cancel. The vast majority of participants, the buyers and sellers of futures contracts, do not intend to take delivery or deliver what they bought or sold. Futures contracts are used as an investment vehicle and as a vehicle for hedging positions.

G-10 countries. The informal term for the Group of 10 countries, which consists of Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, the United Kingdom, and the United States. Switzerland joined in 1984, but the name remains as is.

Gap. The period, in foreign-exchange transactions, between the maturities for purchases and those for sales of each foreign currency (exchange gap). In money market transactions, the period between the maturities of placements (loans) and the maturities of borrowing (deposits) of each currency (money market gap). The former occurs when a currency is purchased against one currency and sold against another, each time for different maturities. The money market gap is created by lending an amount of a certain currency for a longer or shorter period than that for which the same currency is borrowed.

Global bond. A temporary debt certificate issued by a Eurobond borrower, representing the

borrower's total indebtedness. The global bond will subsequently be replaced by individual bearer bonds.

Global line. A bank-established aggregate limit that sets the maximum exposure the bank is willing to have to any one customer on a worldwide basis. See also *Multicurrency line*.

Gray market. A forward market for newly issued bonds that takes the form of forward contracting between market participants during the period between the announcement day of a new issue and the day final terms of the bond issue are signed. Bonds are traded at prices stated at a discount of premium to the issue price.

Group of Seven (G-7). A group of industrialized countries comprising Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

Guidance line. An authorization, unknown to the customer, for a line of credit. If communicated to the customer, the guidance line becomes an advised line of credit commitment.

Hard currency. The term "hard currency" is a carryover from the days when sound currency was freely convertible into "hard" metal, that is, gold. It is used today to describe a currency that is sufficiently sound so that it is generally accepted internationally at face value.

Hedging. A transaction used by dealers in foreign exchange, commodities, or securities, as well as manufacturers and other producers, to protect against severe fluctuations in exchange rates and prices. A current sale or purchase is offset by contracting to purchase or sell at a specified future date. The object is to defer a profit or loss on the current purchase or sale by realizing a profit or loss on a future purchase or sale. The hedge contract may run for a period that coincides with the expected liquidation of the asset or it may merely last for one, three, six, or twelve months to offset the exchange risk for an asset that is expected to be held for a long term, in which case the choice of the term of the hedge is a matter of relative cost and judgment. Also referred to as "covering."

Host currency. See *Local currency*.

Hot money. Funds temporarily transferred to a financial center and subject to withdrawal at any moment.

ICERC. See *Interagency Country Exposure Review Committee*.

Impact loan. A loan specifically designated by a government as important for the development of the country. It usually involves produc-

tion for export. The term is most often used in regard to Japanese loans.

Implied forward rate. The rate of interest at which a borrowing or a lending transaction of a shorter maturity may be rolled over to yield an equivalent interest rate with a borrowing or a lending transaction of longer maturity.

Indirect quote. Quotation of a fixed unit of the local currency in variable units of foreign currencies.

Ineligible acceptance. An acceptance that does not meet the Federal Reserve eligibility requirements for use at the discount window.

In the money. A term used to refer to a call option whose strike price is below or a put option whose strike price is above the current price of the asset on which the option is written.

Initial margin. The minimum deposit a futures exchange requires from customers for any futures contract in which a customer has a net long or short position.

Interagency Country Exposure Review Committee (ICERC). A nine-member joint committee of three federal regulatory agencies established to administer the country risk supervision program. ICERC centralizes decision making for determinations about the credit-worthiness of individual countries.

Interbank offered rate (IBOR). The rate at which banks will lend to other banks for a particular currency at a particular location.

Interest arbitrage. Involves the movement of short-term funds from one currency to another for the purpose of investing idle funds at a higher yield. However, the real yield advantage in this situation is not merely the difference in interest rates between the two investment choices, but rather the difference in subtracting the cost of transferring funds into the desired currency and back again from the interest differential. There are four types of interest arbitrage: (1) covered interest arbitrage (transfer of short-term funds into a foreign currency for the sake of a higher yield, with the exchange risk covered), (2) inward interest arbitrage (transfer of short-term funds into local currency for a higher yield), (3) outward interest arbitrage (transfer of short-term funds into a foreign currency for a higher yield), and (4) uncovered interest arbitrage (transfer of short-term funds into a foreign currency for a higher yield, without covering the exchange risk).

Interest negative. The commission charged on foreign deposits on which no interest is allowed.

Interest parities. Differences at a given time between interest rates charged in two financial centers on short-term credits, investments, or time deposits of identical maturities.

Interest rate. The amount (generally expressed as a per annum percentage) of money charged for allowing another party the use of one's money.

Interest-rate cap. A transaction whereby a bank pays a fee up-front and will later receive payments if a designated interest rate exceeds a minimum threshold established in the contract. If during the contract, interest rates do not exceed the threshold, the bank loses the initial fee paid. By contrast, if interest rates exceed the threshold, a bank will receive progressively higher payments to offset higher interest expense. The payment received represents the difference between the designated rate and the threshold.

Interest-rate collar. The collar combines an interest-rate cap and a floor. A bank buys a cap and pays a fee, which protects the institution should interest rates exceed a stated threshold. The bank simultaneously sells a floor and receives a fee to offset the cost of the cap. The collar establishes a band of interest rates for liabilities—rates cannot exceed the cap's ceiling or the floor's minimum.

Interest-rate differential. The difference between the interest rates on two different currencies. Also the swap rate between two currencies expressed as a per annum percentage premium or discount.

Interest-rate floor. The floor obligates a seller to pay funds to the buyer if a specified interest rate falls below a strike rate.

Interest-rate futures. Interest-rate futures contracts offer a vehicle through which banks can shift interest-rate risk to the market for financial futures. Interest-rate futures are analogous to futures contracts on commodities. See also *Futures market*.

Interest-rate swap. A contractual obligation entered into by two parties to deliver a fixed sum of money against a variable sum of money at periodic intervals. It typically involves an exchange of payments on fixed- and floating-rate debt. If the sums involved are in different currencies, the swap is simultaneously an interest-rate swap and a currency swap.

International Banking Act of 1978 (IBA). The principal legislation pertaining to the activities of foreign banks in the United States. It established a policy of national treatment of foreign

banks with regard to their operations in the United States.

International banking facility (IBF). A set of asset and liability accounts segregated on the books and records of a depository institution, U.S. branch or agency of a foreign bank, or an Edge Act or agreement corporation. IBF activities are essentially limited to accepting deposits from and extending credit to foreign residents (including banks), other IBFs, and the institutions establishing the IBF. IBFs are not required to maintain reserves against their time deposits or loans. IBFs may receive certain tax advantages from individual states.

International Center for Settlement of Investment Disputes (ICSID). See *World Bank*.

International Lending Supervision Act (ILSA). Enacted in 1983, the act requires U.S. banking agencies to consult with bank supervisory authorities in other countries to achieve consistent policies and practices in international lending.

International Monetary Fund (IMF). A specialized agency of the United Nations, the IMF encourages monetary cooperation, promotes stable exchange policy, and makes short-term advances and standby credits to members experiencing temporary payments difficulties. Its resources come mainly from subscriptions of members.

International Money Market of the Chicago Mercantile Exchange (IMM). The IMM is one of the world's largest markets for foreign-currency and Eurodollar futures trading.

International Swap Derivatives Association (ISDA). A trade association for derivative contracts.

Intervention. The actions of a central bank designed to influence the foreign-exchange rate of its currency. The bank can use its exchange reserves to buy its currency if it is under too much downward pressure or to sell its currency if it is under too much upward pressure.

Intracountry foreign-currency exposure. The risk that exists whenever a subsidiary or a branch lends, invests, places, or extends credit to entities that are located within the same country as the booking unit, but in a currency different from that of the country where the borrower and the booking unit are located.

Intraday position. The size of spot and forward positions allowed for a dealer during the business day, which may be larger than that allowed for the end of the date. Sometimes also called "daylight" limits.

Intrinsic value. The amount, if any, by which the current market price of the underlying instrument is above the exercise price for calls and below the exercise price for puts.

Issue price. The price at which a new issue of securities is placed on sale.

Joint venture. The participation of two or more entities in a single business activity. Used to facilitate entry into a market in which other forms of operation may be proscribed.

Last trading date. The final day on a futures or options exchange when trading may occur in a given futures contract month or in a given option series.

Latin American Free Trade Association (LAFTA). An association consisting of Argentina, Brazil, Colombia, Ecuador, Mexico, Paraguay, Peru, and Uruguay.

Lead manager. The commercial or investment bank with the primary responsibility for organizing a syndicated bank credit or bond issue. This includes the recruitment of additional lending or underwriting banks, the negotiation of terms with the borrower, and the assessment of market conditions.

Lending margin. The fixed percentage above the reference rate paid by a borrower in a rollover credit or on a floating-rate note.

Letter of credit—advised. An export letter of credit issued by a bank that requests another bank to advise the beneficiary that the credit has been opened in its favor. This occurs when the issuing bank does not have an office in the country of the beneficiary and uses the facilities of the advising bank. The advising bank is potentially liable only for its own error in making the notification.

Letter of credit—back-to-back. A letter of credit issued on the strength (or "backing") of another letter of credit, involving a related transaction and nearly identical terms. For example, ABC company in the United States is designated as the beneficiary of an irrevocable letter of credit confirmed by a U.S. bank to supply XYZ company in Bolivia, whose bank issued the letter of credit, with goods to be purchased from a third company. The third company, however, will not fill ABC's order unless it receives prepayment for the goods, either through cash or some other type of financing. If ABC is unable to prepay in cash, it will request its bank to issue a letter of credit in favor of the third company. If ABC's bank agrees, the domestic credit is then "backed" by the foreign letter of credit and

a back-to-back letter-of-credit transaction exists.

Letter of credit—cash. A letter addressed from one bank to one or more of its correspondents that makes available to a party named in the letter a fixed sum of money up to a future specific date. The sum indicated in the letter is equal to an amount deposited in the issuing bank by the party before the letter is issued.

Letter of credit—commercial. A letter addressed by a bank, on behalf of a buyer of merchandise, to a seller authorizing the seller to draw drafts up to a stipulated amount under specified terms and undertaking conditionally or unconditionally to provide payment for drafts drawn.

- *Confirmed irrevocable letter of credit*—A letter in which a bank in addition to the issuing bank is responsible for payment.
- *Irrevocable letter of credit*—A letter in which the issuing bank waives all right to cancel or in any way amend without consent of the beneficiary or seller.
- *Revocable letter of credit*—A letter in which the issuing bank reserves the right to cancel or amend that portion of the amount that has not been demanded before the actual payment or negotiation of drafts drawn.
- *Revolving credit*—A letter in which the issuing bank notifies a seller of merchandise that the amount of credit when used will again become available, usually under the same terms and without the issuance of another letter.
- *Special clauses*—
 - *Green clause*—Similar to the red clause letter of credit below, except that advance payment is made, generally upon presentation of warehouse receipts evidencing storage of the goods.
 - *Red clause*—A clause permitting the beneficiary to obtain payment in advance of shipment so that the seller may procure the goods to be shipped.
 - *Telegraphic transfer clause*—A clause in which the issuing bank agrees to pay the invoice amount to the order of the negotiating bank upon receipt of an authenticated cablegram from the latter that the required documents have been received and are being forwarded.

Letter of credit—confirmed. A letter of credit issued by the local bank of the importer and to which a bank, usually in the country of the exporter, has added its commitment to honor

drafts and documents presented in accordance with the terms of the credit. Thus, the beneficiary has the unconditional assurance that, if the issuing bank refuses to honor the draft against the credit, the confirming bank will pay (or accept) it. In many instances, the seller (exporter) may ask that the letter of credit be confirmed by another bank when the seller is not familiar with the foreign issuing bank or as a precaution against unfavorable exchange regulations, foreign-currency shortages, political upheavals, or other situations.

Letter of credit—deferred payment. A letter of credit under which the seller's draft specifies that the draft is payable at a later date, for example, 90 days after the bill-of-lading date or 90 days after presentation of the documents.

Letter of credit—export. A letter of credit opened by a bank, arising from the financing of exports from a country. The issuing bank may request another bank to confirm or advise the credit to the beneficiary. If confirmed, the credit becomes a confirmed letter of credit, and, if advised, it becomes an advised (unconfirmed) letter of credit.

Letter of credit—guaranteed. A letter of credit guaranteed by the customer (applicant) and often backed by collateral security. In domestic banks, the payment of drafts drawn under this credit is recorded in the general-ledger asset account "Customer Liability—Drafts Paid Under Guaranteed L/C."

Letter of credit—import. A letter of credit issued by a bank on behalf of a customer who is importing merchandise into a country. Issuance of an import credit carries a definite commitment by the bank to honor the beneficiary's drawings under the credit.

Letter of credit—irrevocable. A letter of credit that cannot be modified or revoked without the customer's consent or that cannot be modified or revoked without the beneficiary's consent.

Letter of credit—negotiation. A letter of credit requiring negotiation (usually in the locality of the beneficiary) on or before the expiration date. The engagement clause to honor drafts is in favor of the drawers, endorsers, or bona fide holders.

Letter of credit—nontransferable. A letter of credit that the beneficiary is not allowed to transfer in whole or in part to any party.

Letter of credit—reimbursement. A letter of credit issued by one bank and payable at a second bank that, in turn, draws on a third bank for reimbursement of the second bank's pay-

ment to the beneficiary. Those credits are generally expressed in a currency other than that of the buyer (issuing bank) or the seller, and, because of wide acceptability, many are settled in the United States through yet another bank as the reimbursing agent. Upon issuance, the correspondent sends the reimbursing bank an authorization to honor drawings presented by the negotiating bank.

Letter of credit—revocable. A letter of credit that can be modified or revoked by the issuing bank up until the time payment is made.

Letter of credit—revolving. A letter of credit issued for a specific amount that renews itself for the same amount over a given period. Usually, the unused renewable portion of the credit is cumulative as long as drafts are drawn before the expiration of the credit.

Letter of credit—standby. A letter of credit or similar arrangement, however named or described, that represents an obligation to the beneficiary on the part of the issuer—

- to repay money borrowed by or advanced to or for the account party,
- to make payment on account of any indebtedness undertaken by the account party, or
- to make payment on account of any default by the account party in the performance of an obligation.

Letter of credit—straight. A credit requiring presentation on or before the expiration date at the office of the paying bank. The engagement clause to honor drafts is in favor of the beneficiary only.

Letter of credit—transferable. A credit under which the beneficiary has the right to give instructions to the bank called upon to effect payment or acceptance to make the credit available in whole or in part to one or more third parties (second beneficiaries). The credit may be transferred only upon the express authority of the issuing bank and provided that it is expressly designated as transferable. It may be transferred in whole or in part, but may only be transferred once.

Letter of credit—traveler's. A letter of credit addressed to the issuing bank's correspondents, authorizing them to negotiate drafts drawn by the beneficiary named in the credit upon proper identification. The customer is furnished with a list of the bank's correspondents. Payments are endorsed on the reverse side of the letter of credit by the correspondent banks when they negotiate the drafts. This type of letter of credit is usually prepaid by the customer.

Letter of credit—usance. A letter of credit that calls for payment against time drafts, drafts calling for payment at some specified date in the future. Usance letters of credit allow buyers a grace period of a specified number of days, usually not longer than six months.

London Interbank Offered Rate (LIBOR). The rate at which, theoretically, banks in London place Eurocurrencies/Eurodollars with each other.

London International Financial Futures Exchange (LIFFE). A London exchange where foreign-currency and Eurodollar futures, as well as foreign-currency options, are traded on spot exchange.

Limits (bank customer—foreign-exchange and interbank). Maximum line amounts allowed with other banks for forward exchange transactions, Eurocurrency and Eurodollar transactions, and payments arising from foreign-exchange transactions on the same day.

Listing. The formal process required to have a security regularly quoted on an exchange. Eurobonds are usually listed so that they can be purchased by those institutional investors who are constrained to invest in listed securities.

Local-currency exposure. The amount of assets and nonbalance-sheet items that are denominated in the local currency of that country.

Lock-up. The term used to refer to procedures followed in a Eurobond issue to prevent the sale of securities to U.S. investors during the period of initial distribution.

Long position. An excess of assets (and/or forward purchase contracts) over liabilities (and/or forward sale contracts) in the same currency. A dealer's position when the net purchases and net sales leave him or her in a net-purchased position.

Loro accounts. Current accounts banks hold with foreign banks in a foreign currency on behalf of their customers.

Maintenance margin. The minimum equity a futures exchange requires in a customer's account for each futures contract subsequent to deposit of the initial margin.

Managed float. See *Dirty float*.

Management fee. The fee received by lead banks as compensation for managing a large-syndicate financing.

Manager of participation. The original lender of any loan in which participations are later sold and who generally has a fiduciary relationship with the other lenders. See also *Agent bank*.

Manager of syndicate. The bank that solicits the loan from the borrower and solicits other lenders to join the syndicate making the loan.

Margin. The amount of money and/or securities that must be posted as a security bond to ensure performance on a contract.

Marine insurance. Insurance for losses arising from specified marine casualties. Marine insurance is more extensive than other types as it may provide not merely for losses arising from fire, but also from piracy, wrecks, and most injuries sustained at sea.

- *Average*—A term in marine insurance signifying loss or damage to merchandise.
- *General average*—A loss arising from a voluntary sacrifice of any portion of a shipment or cargo to prevent loss of the whole and for the benefit of all persons at interest. The value of this loss is apportioned not only among all the shippers, including those whose property is lost, but also to the vessel itself. Until the assessment is paid, a lien lies against the whole cargo.
- *Particular average*—A partial loss or damage of merchandise caused by a peril insured against and that does not constitute a general average loss.
- *Free of particular average (F.P.A.)*—Insurance against partial loss regardless of the percentage of the loss.
- *Casco insurance*—Marine insurance on the ship itself (hull) that is usually purchased by the owners.
- *Cover note*—English equivalent of American binder.
- *Open policy*—A contract between an insurance company and a shipper by which all shipments made by the insured are automatically protected from the time the merchandise leaves the initial shipping point until delivery at destination.

Mark-to-market. The revaluation of a traded asset or commodity to reflect the most recently available market price.

Market-maker. A bank or other financial institution that gives two-sided (bid and offer) quotations. A market-maker stands prepared to do business on either side of the market without knowing if the inquiring institution intends to buy or sell.

Market order. An order that is to be executed immediately at the best available price in the market.

Matched. A forward purchase is matched when it is offset by a forward sale for the same

date or vice versa. As a necessity, however, when setting limits for unmatched positions, a bank may consider a contract matched if the covering contract falls within the same week or semimonthly period.

Maturity date. The settlement date or delivery date for a forward contract.

Medium-term notes. Intermediate-term notes that carry a maturity between nine months and ten years.

Merchant bank. A European form of an investment bank.

Money market. A wholesale market for low-risk, highly liquid, short-term debt instruments.

Multicurrency line. A line of credit that gives the borrower the option of using any of the readily available major currencies.

Multilateral exchange contract. An exchange contract involving two foreign currencies against each other, for example, a contract for U.S. dollars against French francs made in London or a contract for British pounds against German marks made in New York. Also called an arbitrage exchange contract.

Multinational bank. A commercial bank engaged in selling services or conducting operations in more than one country.

Nationalization. The act whereby a central government assumes ownership and operation of private enterprises within its territory.

Negative interest. A fee charged by a bank for accepting a deposit from a customer. This can happen when a currency is under pressure to appreciate. A central bank in this situation can establish capital-import controls and limit the amount of deposits that a bank can receive from nonresidents. If market participants want to deposit more money in the country than the central bank will allow, interest rates will drop initially to zero and, if the pressure continues, produce negative interest. Any taxes that a central bank may impose on foreign deposits can also create negative interest.

Negative pledge. A contractual promise by a borrower in a syndicated loan or a bond issue not to undertake some future action. One typical negative pledge is that future new creditors will not be given rights greater than those of existing creditors.

Negotiable instruments. Written orders or promises to pay that may be transferred by endorsement or delivery, for example, by checks, bills of exchange, drafts, and promissory notes. Governed by article 3 of the Uniform Commercial Code.

Negotiate. (1) Letters of credit—To verify that the documents presented under a letter of credit conform to requirements and then, if the documents are in order, to pay the seller of the goods. (2) Negotiable instruments—To transfer possession of an instrument by a person other than the issuer to another person who thereby becomes its holder.

Net accessible interest differential. The difference between the interest rates that can actually be obtained on two currencies. This difference is usually the basis of the swap rate between the two currencies and, in most cases, is derived from external interest rates rather than domestic ones. These external rates, or Euro-rates, are free from reserve requirements (which would increase the interest rate) and from exchange controls (which would limit access to the money).

Net exchange position. An imbalance between all the assets and purchases of a currency, and all the liabilities and sales of that currency.

Net position. A bank has a net position in a foreign currency when its assets (including future contracts to purchase) and liabilities (including future contracts to sell) in that currency are not equal. An excess of assets over liabilities, including future contracts, is called a net “long” position, and liabilities in excess of assets result in a net “short” position. A net long position in a currency that is depreciating results in a loss because, with each day, the position is convertible into fewer units of local currency. A net short position in a currency that is appreciating represents a loss because, with each day, satisfaction of the position costs more units of local currency.

Netting arrangement. Agreement by two counterparties to examine all contracts settling in the same currency on the same day and to agree to exchange only the net currency amounts. Also applies to net market values of several contracts.

Nominal interest rate. The interest rate stated as a percentage of the face value of a loan. Depending on the frequency of interest collection over the life of the loan, the nominal rate may differ from the effective interest rate.

Nonrevolving. A line of credit that cannot be reused once it has been drawn down to a specified amount.

Nostro accounts. Demand accounts of banks with their correspondents in foreign countries in the currency of that country. These accounts are used to make and receive payments in foreign currencies for a bank’s customers and to settle

maturing foreign-exchange contracts. Also called due from foreign bank—demand accounts, our balances with them, or due from balances.

Novation. The substitution of a new party for one of the original parties to a contract. The result is a new contract with the same terms, but at least one new party.

Odd dates. Deals within the market are usually for spot, one month, two months, three months, or six months forward. Other dates are odd dates, and prices for them are frequently adjusted with more than a mathematical difference. Hence, most market deals are for regular dates, although commercial deals for odd dates are common.

Offer rate. The price at which a quoting party is prepared to sell or lend currency. This is the same price at which the party to whom the rate is quoted will buy or borrow if it desires to do business with the quoting party. The opposite transactions take place at the bid rate.

Offering circular. A document giving a description of a new securities issue, as well as a description of the entity making the issue.

Office of Foreign Asset Control (OFAC). An office within the U.S. Treasury Department that administers U.S. laws imposing economic sanctions against targeted hostile foreign countries. While OFAC is responsible for administration of these statutes, all of the bank regulatory agencies cooperate in ensuring compliance.

Official rate. The rate established by a country at which it permits conversion of its currency into that of other countries.

Offshore branch. Banking organization designed to take advantage of favorable regulatory or tax environments in another country. Many of these operations are shell branches with no physical presence.

Offshore dollars. The same as Eurodollars, but encompassing the deposits held in banks and branches anywhere outside of the United States, including Europe.

Open contracts (open positions). The difference between long positions and short positions in a foreign currency or between the total of long and short positions in all foreign currencies. Open spot or open forward positions that have not been covered with offsetting transactions. See also *Net position*.

Open interest. The total number of futures contracts for a particular asset that have not been liquidated by an offsetting trade or that have not been fulfilled by delivery.

Open market operations. Purchases or sales of securities or other assets by a central bank on the open market.

Open position limit. A limit placed on the size of the open position in each currency to manage off-balance-sheet items.

Opening bank. The bank that draws up and opens the letter of credit and that makes payment according to the conditions stipulated.

Option contract. A contract giving the purchaser the right, but not the obligation, to buy (call option) or sell (put option) an asset at a stated price (strike or exercise price) on a stated date (European option) or at any time before a stated date (American option).

Organization for Economic Cooperation and Development (OECD). Founded as a successor organization to the Organization for European Economic Cooperation (OEEC). The OEEC was originally established to administer aid under the Marshall Plan during the post-World War II period. The goals of the successor OECD are to stimulate world trade, economic growth, and economic development. Members include Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Mexico, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

Organization of American States (OAS). An organization of 21 American republics (not including Canada) formed to promote inter-governmental cooperation in the Western Hemisphere.

Organization of the Petroleum Exporting Countries (OPEC). A federation of oil-exporting countries that sets petroleum prices for member countries. Members include Iran, Iraq, Kuwait, Saudi Arabia, and Venezuela.

Other transfer risk problems (OTRP). A category assigned by the Interagency Country Risk Exposure Review Committee (ICERC) for countries near default or in noncompliance with their debt requirements.

Out-of-the-money. A term used to refer to a call option whose strike price is above or to a put option whose strike price is below the current price of the asset on which the option is written.

Outright. Forward exchange bought and sold independently from a simultaneous sale or purchase of spot exchange.

Outright forward rate. A forward exchange rate that is expressed in terms of the actual price

of one currency against another, rather than, as is customary, by the swap rate. The outright forward rate can be calculated by adding the swap premium to the spot rate or by subtracting the swap discount from the spot rate.

Overbought. The position of a trader who has bought a larger amount of a commodity or asset than he or she has sold.

Overnight. A swap transaction involving same-day settlement of the spot transaction against a value date of the next business day on the forward contract.

Overnight position. A foreign-exchange or money market position maintained overnight. There is more risk involved in this position than in one maintained during the day because political and economic events may take place at night when the operator cannot react immediately to them.

Override limit. The total amount of money (measured in terms of a bank's domestic currency) that the bank is willing to commit to all foreign-exchange net positions.

Oversold. The position of a trader who has sold a larger amount of a certain asset or commodity than he or she has bought.

Over-the-counter (OTC). Transactions not conducted in an organized exchange. OTC markets have no fixed location or listing of products.

Paris Club. An ad hoc group of western creditor governments that meets informally under the chairmanship of the French Treasury. Its function is to start the process of rescheduling a country's official debt.

Parity. A term derived from par, meaning the equivalent price for a certain currency or security relative to another currency or security, or relative to another market for the currency or security after making adjustments for exchange rates, loss of interest, and other factors.

Parity grid. The system of fixed bilateral par values in the European Monetary System. The central banks of the countries whose currencies are involved in an exchange rate are supposed to intervene in the foreign-exchange market to maintain market rates within a set range defined by an upper and a lower band around the par value.

Participation. The act of taking part in a syndicated credit or a bond issue.

Par value. The official parity value of a currency relative to the dollar, gold, Special Drawing Rights, or another currency.

Paying agent. A bank or syndicate of banks responsible for paying the interest and principal of a bond issue to bondholders on behalf of the bond issuer.

Performance bond. A bond supplied by one party to protect another against loss in the event of the default of an existing contract.

Placement memorandum. A document in a syndicated Eurocredit that sets out details of the proposed loan and gives information about the borrower.

Political risk. Political changes or trends, often accompanied by shifts in economic policy, that may affect the availability of foreign exchange to finance private or public external obligations. The banker must understand the subtleties of current exchange procedures and restrictions, as well as the possibilities of war, revolution, or expropriation in each country with which the bank transacts business, regardless of the actual currencies involved.

Portfolio investment. An investment in an organization, other than a subsidiary or joint venture, in which less than 20 percent of the voting shares are held.

Position. A situation created through foreign-exchange contracts or money market contracts in which changes in exchange rates or interest rates could create profits or losses for the operator.

Position book. A detailed, ongoing record of an institution's dealings in a particular foreign-currency or money market instrument.

Position risk. See *Net position*.

Position-trader. A speculator in the futures market who takes a position in the market for a period of time.

Premium. The adjustment to a spot price that is made in arriving at a quote for future delivery. If a dealer were to quote \$2.00 and \$2.05 (bid and asked) for sterling, and the premiums for six months forward are 0.0275 and 0.0300, the forward quotes would be adjusted to \$2.0275 and \$2.0800. The premium usually represents differences in interest rates for comparable instruments in two countries. However, in periods of crisis for a currency, the premium may represent the market anticipation of a higher price.

Price quotation system. A method of giving exchange rates in which a certain specified amount of a foreign currency (1 or 100, usually) is stated as the corresponding amount in local currency.

Primary dealers. Securities firms that are recognized by the Federal Reserve System to buy and sell securities with the Fed.

Private placement. The process of negotiating for the sale of securities, debt, equity, or a combination thereof to a relatively small group of investors.

Protest. The formal legal process of demanding payment of a negotiable item from the maker or drawee who has refused to pay.

Public Law (P.L.) 480. The most common reference to the Agricultural Trade Development and Assistance Act of 1954. Generally, P.L. 480 authorizes the President to provide various types of assistance to American agricultural exporters, such as making sales in the currency of the destination country.

Put. The ability of the bank to require repayment of the debt of a borrower by a third party because of nonperformance of the borrower through an agreement other than a formal guarantee.

Put option. A contract giving the purchaser the right, but not the obligation, to sell a particular asset at a stated strike price on or before a stated date.

Rate risk. In the money market, the chance that interest rates may rise when an operator has a negative money market gap (a short position) or that interest rates may go down when the operator has a positive money market gap (a long position). In the exchange market, the chance that the spot rate may rise when the trader has a net oversold position (a short position), or that the spot rate may go down when the operator has a net overbought position (a long position).

Rate swap. A transaction in which one participant pays a fixed rate of interest on a notional amount for a given period of time and the other pays a floating rate.

Reciprocal rate. The price of one currency in terms of a second currency, when the price of the second currency is given in terms of the first.

Recourse. The ability to pursue judgment for a default on a negotiable instrument against parties who signed the note.

Rembrandt bonds. Dutch guilder-denominated foreign bonds issued in Amsterdam.

Representations. Statements made by a borrower in a syndicated credit or bond issue describing the borrower's financial condition.

Representative office. A facility established in U.S. or foreign markets by a bank to sell its services and assist clients; in the United States,

these offices cannot accept deposits or make loans.

Repurchase agreement (repo or RP). A holder of assets sells those assets to an investor with an agreement to repurchase them at a fixed price on a fixed date. The security “buyer” in effect lends the “seller” money for the period of the agreement, and the terms of the agreement are structured to compensate the buyer for this. Dealers use repo extensively to finance their positions.

Reserve account. Those items in the balance of payments that measure changes in the central bank’s holdings of foreign assets (such as gold, convertible securities, or Special Drawing Rights).

Reserve currency. A foreign currency held by a central bank (or exchange authority) for the purposes of exchange intervention or the settlement of intergovernmental claims.

Reserve requirements. Obligations imposed on commercial banks to maintain a certain percentage of deposits with the central bank or in the form of central-bank liabilities.

Retiming. Restructuring of the timing of interest payable on bonds.

Revaluation. An official act wherein the parity of a currency is adjusted relative to the dollar, gold, Special Drawing Rights, or another currency, resulting in less revalued units relative to those currencies. (See also *Devaluation*.) Also, the periodic computations of the current values (revaluations) of ledger accounts and unmatured future purchase and sales contracts.

Revolving credit. A line of bank credit that may be used at the borrower’s discretion. Interest is paid on the amount of credit actually in use, while a commitment fee is paid on the unused portion.

Revolving into term. A commitment that allows a revolving line of credit (usually one to three years) with term provision at the expiration of the revolver for an additional period of time. Most common is a two-year revolver with a five-year, fully amortizing term portion.

Revolving line of credit. A line of credit that permits successive drawings and payments at the borrower’s discretion. The funds available to the borrower are replenished by any payments of principal.

Risk-management tools. Financial devices (such as futures or options) that permit a borrower or lender of funds to protect against the

risks of changing currency prices and/or interest rates.

Risk participation. An agreement whereby a bank shares the risk in an outstanding credit or instrument. Credit-equivalent amounts of risk participations are assigned based on the risk category appropriate to the account party obligation or, if relevant, to the nature of the collateral or guarantees. Usually treated as a direct credit substitute.

Rollover. The process of selling new securities to pay off old ones coming due, refinancing an existing loan, or extending a maturing forward foreign-exchange contract.

Rollover credit. A bank loan with an interest rate periodically updated to reflect market interest rates. The interest rate in the loan for each subperiod is specified as the sum of a reference rate and a lending margin.

Rollover date. The end of an interest period in a revolving term loan.

Same-day funds. Federal funds, or the equivalent, used in the settlement of a transaction that will probably create an interest adjustment of the trading rate to compensate for the difference in the availability of the funds for use.

Samurai bonds. Yen-denominated bonds issued by a foreign borrower in Japan.

Scalpers. Floor or pit traders in the futures market with short-term horizons who sell slightly above the most recent trade and buy at a price slightly below.

Seasoned securities. Securities that have traded in the secondary market for more than 90 days.

Secondary market. A market in which securities are traded following the time of their original issue.

Selling concession. The share of total investment-banking fees accruing to the selling group.

Selling group. All banks involved in selling or marketing a new issue of bonds. Sometimes the term is used in reference to dealers acting only as sellers and is intended to exclude reference to underwriters or managers.

Seller’s option contract. A contract in which the seller has the right to settle a forward contract at his or her option anytime within a specified period. See also *Option contract*.

Selling rates. Rates at which dealers are prepared to sell foreign exchange in the market.

Settlement day. The day on which the actual transfer of two currencies or the transfer of

money for an asset takes place at a previously arranged price.

Settlement price. The official daily closing price for a futures or option contract. This price is established and used by a clearinghouse to determine each clearing firm's settlement variation.

Settlement risk. The possibility that a seller of foreign exchange or securities, having collected the payment in local currency, may fail to deliver the exchange or securities to the buyer.

Settlement variation. The sum of all changes in amount for each of a firm's futures or options positions as calculated from each day's settlement price. This amount is paid to or received from the clearinghouse each day based on the previous day's trading.

Shell branch. See *Offshore branch*.

Shogun bonds. Foreign bonds issued in Tokyo and denominated in currencies other than the Japanese yen. The usual denomination is the U.S. dollar.

Short position. An excess of liabilities (and/or forward sale contracts) over assets (and/or forward purchase contracts) in the same currency. A dealer's position when the net of purchases and sales leaves the trader in a net-sold or oversold position.

Sight draft. A draft payable upon presentation to the drawee or within a brief period thereafter known as "days of grace."

Society for Worldwide Interbank Financial Telecommunications (SWIFT). A telecommunications network established by major financial institutions to facilitate messages among SWIFT participants. These messages typically result in a monetary transaction between institutions. The network is based in Brussels.

Soft currency. A currency that is not freely convertible into other currencies.

Soft loans. Loans with exceptionally lenient repayment terms, such as low interest, extended amortization, or the right to repay in the currency of the borrower.

Sole of exchange. A phrase appearing on a draft to indicate that no duplicate is being presented.

Sovereign risk. The risk that the government of a country may interfere with the repayment of debt.

Space arbitrage. The buying of a foreign currency in one market and the selling of it for a profit in another market.

Special Drawing Rights (SDRs). International paper money created and distributed to govern-

ments by the IMF in quantities dictated by special agreements among its member countries. The value of SDRs is determined by the weighted value of a "basket" of major currencies.

Specially designated nationals. Persons or entities listed by OFAC. These persons or entities are typically front organizations and are subject to OFAC prohibitions. See also *Blocked account*, *Office of Foreign Asset Control*.

Speculation. The purchase or sale of a trading unit, usually on a forward basis, in hopes of making a profit at a later date. The term is used in the foreign-exchange, commodity, stock, and option markets.

Spot contract. A foreign-exchange contract traded in the interbank market in which the value date is two business days from the trade date.

Spot exchange (or spot currency). Foreign exchange purchased or sold for immediate delivery and paid for on the day of the delivery. Immediate delivery is usually considered delivery in one to two business days after the conclusion of the transaction. Many U.S. banks consider transactions maturing in as many as ten business days as spot exchange. Their reasons vary but are generally to facilitate revaluation accounting policies and to initiate final confirmation and settlement verification procedures on future contracts nearing maturity. See also *Futures (or forward) exchange contract*.

Spot month. The futures-contract month that is also the current calendar month.

Spot/next. In the foreign-exchange market, a term used to describe a swap transaction for value on the spot date with the reverse transaction taking place the next working day after the spot date. In the Eurocurrency market, a term used to describe a loan or deposit for value on the spot date with maturity on the next working day after the spot date.

Spot transaction. A transaction for spot exchange or currency.

Spread. The difference between the bid rate and the offer rate in an exchange-rate quotation or an interest quotation. This difference is not identical with the profit margin because traders seldom buy and sell at their bid and offer rates at the same time. In another sense (for example, Eurodollar loans priced at a mark-up over LIBOR), spread means a mark-up over cost, and, in this context, the spread is identical with the profit margin.

Square exchange position (or square-off). To make the inflows of a given currency equal to

the outflows of that currency for all maturity dates. This produces a square exchange position in that currency.

Stabilization. The efforts by a lead manager in a securities issue to regulate the price at which securities trade in the secondary market, during the period that the securities syndicate is still in existence.

Sterilization. Intervention in the foreign-exchange market by a central bank in which the change in the monetary base caused by the foreign-exchange intervention is offset by open market operations involving domestic assets.

Straight bill of lading. A bill of lading drawn directly to the consignee and therefore not negotiable. See also *Bill of lading*.

Strike price. The price at which an option buyer may purchase (if a call option) or sell (if a put option) the asset upon which the option is written.

Subscription agreement. An agreement between a securities issuer and the managing banks that describes the terms and conditions of the issue and the obligation of the parties to the agreement.

Subscription period. The time period between the day on which a new securities issue is announced and the day on which the terms of the issue are signed and the securities are formally offered for sale.

Subsidiary. Entity in which a bank has a modicum of control. Used to facilitate entry into foreign markets in which other operations are proscribed.

Sushi bonds. Dollar-denominated Eurobonds issued by Japanese companies and purchased primarily by Japanese investors. These bond issues are typically managed by Japanese banks.

Swap. The combination of a spot purchase or sale against a forward sale or purchase of one currency in exchange for another. The trading of one currency (lending) for another currency (borrowing) for that period of time between which the spot exchange is made and the forward contract matures. See also *Swap cost (or profit)*.

Swap arrangement—reciprocal. A bilateral agreement between central banks enabling each party to initiate swap transactions up to an agreed limit to gain temporary possession of the other party's currency.

Swap cost (or profit). In a swap transaction, the cost or profit related to the temporary movement of funds into another currency and back again. That exchange cost or profit must then be

applied to the rate of interest earned on the loan or investment for which the exchange was used. Furthermore, the true trading profits or losses generated by the foreign-exchange trader cannot be determined if swap profits or costs are charged to the exchange function rather than allocated to the department whose loans or investments the swap actually funded.

Swap and deposit. A combination of swap transactions that enables the borrower to have use of both currencies for the duration of the transaction.

Swap position. A situation in which the scheduled inflows of a given currency are equal to the scheduled outflows, but the maturities of those flows are purposely mismatched. The expectation in a swap position is that the swap rate will change and that the gap can be closed at a profit.

Swap rate. The difference between the spot exchange rate of a given currency and its forward exchange rate.

Swap-swap. A swap transaction involving one forward maturity date against another forward maturity date.

Swaption. An option on a swap. It gives the buyer the right, but not the obligation, to enter into an interest-rate swap at a future period of time.

Syndicate. A group of banks that acts jointly, on a temporary basis, to loan money in a bank credit (syndicated credit) or to underwrite a new issue of bonds (bond underwriting syndicate).

Syndicate leader. See *Manager of syndicate*.

Syndicate participation. Usually, a large credit arranged by a group of lenders, each of whom advances a portion of the required funds. It differs from a participation loan because the banks participate at the outset and are known to the borrower.

Take-down. The receipt of the principal of a loan by the borrower.

Tariff. A duty or tax on imports that can be either a percentage of cost or a specific amount per unit of import.

Telegraphic transfer (TT) rate. The basic rate at which banks buy and sell foreign exchange. Buying rates for mail transfers, foreign-currency drafts, traveler's checks, and similar instruments are all based on the TT rate. The TT rate may be slightly less favorable than other rates because of the time required for collection. Foreign-currency time (usance) drafts also are bought at the TT rate, but interest to maturity is deducted for the time which must elapse until maturity.

Telex. Direct communication between two banks or companies and organizations via satellite or underwater cable.

Tenor. A term designating payment of a draft as being due at sight, a given number of days after sight, or a given number of days after the date of the draft.

Term structure. The level of interest rates on debt instruments of a particular type, viewed as a function of term to maturity. The interest-rate level may rise or fall with increasing maturity.

Terms of trade. Relative price levels of goods exported and imported by a country.

Test key. A code used in transferring funds by cable or telephone so that the recipient may authenticate the message. A test key generally consists of a series of numbers, including a fixed number for each correspondent bank; a number for the type of currency; a number for the total amount; and, possibly, numbers for the day of the month and day of the week. A single number code indicates whether the total amount is in thousands, hundreds, tens, or digits. To arrive at a test number, the indicated numbers are totaled, and the total amount usually precedes the text of the message.

Third-country bills. Banker's acceptances issued by banks in one country that finance the transport or storage of goods traded between two other countries.

Tied loan. A loan made by a governmental agency that requires the borrower to spend the proceeds in the lender's country.

Time draft. A draft drawn to mature at a fixed time after presentation or acceptance.

Time value. The amount by which an option's market value exceeds its intrinsic value.

Tombstone. In a syndicated credit, an advertisement placed in a newspaper or magazine by banks to record their participation in the loan or, in a bond issue, to record their role in managing, underwriting, or placing the bonds.

Tomorrow next (tom/next). The simultaneous purchase and sale of a currency for receipt and payment on the next and second business day, respectively, or vice versa.

Tradable amount. The minimum amount accepted by a foreign-exchange broker for the interbank market, for example, 100,000 Canadian dollars or 50,000 pounds sterling.

Trade acceptance. A draft drawn by the seller (drawer) on the buyer (drawee) and accepted by the buyer. Also called a trade bill, customer acceptance, and two-name trade paper. See also *Acceptance*.

Trade accounts. Those parts of the balance of payments that reflect money spent abroad by the citizens of a country on goods and services and the money spent by foreigners in the given country for goods and services.

Trader's (or dealer's) ticket (slip). The handwritten record of a foreign-exchange trade and/or placing and taking of deposits that is written by the dealer who executed the transaction.

Trading position worksheet. A record of incomplete transactions in a particular currency.

Tranche. One of a number of drawings of funds made by a borrower under a term loan.

Transaction date. The date on which a contract's terms are negotiated and agreed on.

Transfer risk. The risk arising when a borrower incurs a liability in a currency that is not the currency in which revenues are generated. The borrower may not be able to convert its local currency to service an international loan if foreign exchange is not generated.

Trending of rates. Quoting a slightly higher or lower two-way rate in order to reflect a preference for either purchasing or selling.

Trust receipt. Used extensively in letter-of-credit financing, this is a document or receipt in which the buyer promises to hold the property received in the name of the releasing bank, although the bank retains title to the goods. The merchant is called the trustee, the bank the entruster. Trust receipts are used primarily to allow an importer to take possession of the goods for resale before payment to the issuing bank.

Two-way quotation. A simultaneous quotation of foreign-exchange buying and selling rates implying the willingness of the bank to deal either way.

Two-way rate. An exchange-rate or an interest-rate quotation that contains both a bid rate and an offer rate. The size of the spread between the two rates indicates the relative quality of the quotation.

Unconfirmed letter of credit. See *Letter of credit—advised*.

Undervalued. Decline of the spot rate below purchasing power parities, so that the goods of one country are cheaper than in another country. In relation to forward exchange, "undervalued" means that forward premiums are narrower or forward discounts are wider than the interest parities between the two financial centers.

Underwriting allowance. The share of total investment-banking fees accruing to the underwriting group.

Underwriting syndicate. The banks, in a new securities issue, that agree to pay a minimum price to the borrower even if the securities cannot be sold on the market at a higher price.

Uniform customs and practices for documentary credits. Sets of rules governing documentary letters of credit formulated by the International Chamber of Commerce. Includes general provisions, definitions, forms, responsibilities, documents, and the transfer of documentary letters of credit.

Unmatched. A forward purchase is unmatched when a forward sale for the same date has not been executed or vice versa.

Unmatured transactions. Trading transactions that have not reached their settlement dates.

Usance. The period of time between presentation of a draft and its maturity. See also *Tenor*.

Value-compensated. The payment or collection of a settlement cost on an open forward contract to cancel the contract rather than to execute an offsetting contract for the same maturity date.

Value date. The date on which foreign exchange bought and sold must be delivered and on which the price for the exchange must be paid.

Value-impaired. A category assigned by the Interagency Country Exposure Review Committee that indicates a country has protracted debt problems.

Value today. An arrangement by which spot exchange must be delivered and paid for on the day of the transaction instead of two business days later.

Value tomorrow. An arrangement by which spot exchange must be delivered and paid for on the business day following the transaction instead of two business days after the transaction.

Variation margins. Positive or negative changes in the value of a security bought on margin or a futures contract. These variations must be paid daily in cash. All securities bought or sold on margin and futures contracts are marked to market.

Volatility. The standard deviation of changes in the logarithm of an asset price, expressed at a yearly rate. The volatility is a variable that appears in option formulas.

Volume quotation system. A method of giving exchange rates in which a certain specified amount of local currency (usually 1 or 100) is stated as the corresponding amount in foreign currency.

Vostro account. A demand account maintained for a bank by a correspondent bank in a foreign country. The nostro account of one bank is the vostro account of the other bank. See also *Nostro account*.

Warehouse receipt. An instrument that lists and is a receipt for goods or commodities deposited in the warehouse that issues the receipt. These receipts may be negotiable or non-negotiable. A negotiable warehouse receipt is made to the “bearer,” while a nonnegotiable warehouse receipt specifies precisely to whom the goods shall be delivered. There are several alternatives for releasing goods held under warehouse receipts: (1) the delivery of goods may be allowed only against cash payment or substitution of similar collateral; (2) some or all of the goods may be released against the trust receipt without payment, or (3) a warehouseman may release a stipulated quantity of goods without a specific delivery order. Banks will accept a warehouse receipt as collateral for a loan only if the issuer of a receipt is a bonded warehouseman. The bank must have protected assurances for the authenticity of the receipt and the fact that the commodities pledged are fully available as listed on the warehouse receipt.

Wash. A transaction that produces neither profit nor loss.

Wire. Often the words “wire” and “cable” are used interchangeably. In some cases, “wire” denotes messages sent within the confines of the United States, and “cable” refers to messages transmitted overseas. Others use “wire” to mean a transfer of funds by telephone rather than by cable, telex, or telegram.

Withholding tax. A tax imposed by a country on the gross amount of payments to a foreign lender from an in-country borrower.

Within-line facility (or facilities). Subfacilities of the line of credit that establish parameters, terms, and conditions of various other facilities available for specific additional purposes or transactions. The aggregate sum of all outstandings under within-line facilities must not exceed the total of the overall line of credit.

World Bank (The International Bank for Reconstruction and Development). An international financial organization whose purpose is to aid the development of productive facilities in member countries, particularly in developing countries. The chief source of funds is capital contributions made by member countries, which vary with the financial strength of the country.

Another funding source is the sale of long-term bonds.

Writer. An individual who issues an option and, consequently, has the obligation to sell the asset (if the option is a call) or to buy the asset (if the option is a put) on which the option is written if the option buyer exercises the option.

Yankee bond. A dollar-denominated foreign bond issued in the U.S. market.

Yield curve. The interest rates for each different tenor or maturity of a financial instrument. A graph of the yield curve has interest rates on the vertical axis and time-to-maturity on the horizontal axis. When longer maturities have higher

interest rates than shorter maturities, the curve is called a positive or upward-sloping yield curve. The opposite type of curve is called a negative, downward-sloping, or inverted yield curve. When interest rates are the same for all maturities, the curve is called a flat yield curve. See also *Term structure*.

Yield to maturity. The rate of interest on a bond when calculated as that rate of interest which, if applied uniformly to future time periods, sets the discounted value of future bond coupon and principal payments equal to the current market price of the bond.

Zero coupon bond. A bond that pays no interest but that is redeemed at its face value at maturity.

Although the methods of international loan portfolio management are similar to those established for domestic lending, the additional risks in international lending require specialized expertise and careful management by the bank. Banks conducting international lending activities should establish strong policies that include not only the basic components found in domestic policies but also the following segments.

Geographic limits. The bank should delineate those countries or geographic areas where it can lend profitably and soundly in accordance with its objectives and in consideration of country risks. International lending officers must know the specific country limits established by the board of directors, and the bank should have a monitoring system to ensure adherence to those limits. The limits established will depend on each bank's available financial resources, the qualifications and skills of its staff, the extent of its lending activities, and its further growth potential.

Distribution by category. Limitations based on aggregate percentages of total international loans in real estate, consumer credit, ship financing, or other categories are common. Although loan distribution policy may differ among banks, international loans are generally granted in the following categories:

- import and export financing
- loans to corporations or their overseas branches, subsidiaries, or affiliates with a parent guarantee or other form of support
- loans granted to foreign local borrowers including foreign entities of U.S. concerns that borrow without any form of support from the parent corporation
- loans and placements to foreign banks or to overseas branches of U.S. banks
- loans to foreign governments or foreign governmental entities

The categories of credit extensions that the bank's international division should engage in and the nature of any limitations will depend on the particular bank and its customers. Deviations from policy limitations that have been approved by the board of directors or its designated committee(s) should be allowed to meet the changing requirements of the bank's custom-

ers. During times of heavy loan demand in one category, an inflexible loan distribution policy could cause that category to be slighted in favor of another.

Types of credits. The lending policy should state the types of international credits that the bank can make and set guidelines to follow in granting specific credits. The decision about the types of credits to be granted should be based on consideration of the expertise of the lending officers, deposit structure of the bank, and anticipated credit needs of its customers. Complex credits requiring more than normal policing should be avoided unless or until the bank obtains the necessary personnel to administer those credits properly. Types of credit that have resulted in an abnormal loss to the bank's international division should be controlled or avoided within the framework of stated policy. Syndications and other types of term loans should be limited to a given percentage of the bank's stable funds.

Maximum maturities. International credits should be granted with realistic repayment plans. Maturity scheduling should be related to the anticipated source of repayment, the purpose of the credit, the useful life of the collateral, and the degree of country risk. For term loans, a lending policy should state the maximum number of months during which loans may be amortized. Specific procedures should be developed for situations requiring balloon payments and modifications to the original terms of a loan. If the bank requires a cleanup (out-of-debt) period for lines of credit, that period should be explicitly stated.

Loan pricing. Interest rates, fees, commissions, and discounts on various loan types established by the loan policy must be sufficient to cover the costs of funds loaned, servicing of the loan (including general overhead), and probable losses, while providing for a reasonable rate of return. Periodic review allows the rates to be adjusted to account for changes in costs and competitive factors. Additionally, the bank must establish practices to ensure a continuous examination of the relationships between loan pricing and the cost of funds.

Foreign-exchange risks. Lending policy should include controls that minimize risks for loan

portfolios in one currency funded by borrowings in another. These activities must be identified and should be limited by the bank if—

- a particular foreign government is expected to impose stringent exchange controls;
- the currencies involved are or will be subject to wide exchange-rate fluctuations; or
- political, social, or economic developments are likely to intensify exchange risks.

Multicurrency credit commitments permit borrowers to select from a specific list of currencies the one they prefer to use in each rollover period. The listed currencies, however, may be unavailable or available only at a high cost. The bank should protect itself by stating in the loan agreement that its requirement to provide any of the currencies listed is subject to availability at the time requested by the borrower. For detailed information on foreign-exchange risks, see section 7100, “International—Foreign Exchange.”

Documentation and collateral. Trade financing often represents a significant amount of an international division’s lending activity. In this type of financing, the bank deals only in documents, while its customer is responsible for the merchandise under the terms of the sales contract. The bank’s control of documents, especially title documents, is crucial. Lending officers and applicable personnel, therefore, must be knowledgeable in handling documentation, which may be the bank’s ultimate support for certain transactions.

The bank must establish policies for taking overseas collateral as security for a loan to ensure that local required procedures are met. For example, in many countries, liens on fixed assets must be registered with the local government, depending on the type of asset. Lending against current assets also requires special care and monitoring. The bank must know which countries do not recognize the legality of trust receipts as recognized in the United States. In other countries, borrowers sign powers of attorney or similar documents permitting lenders to take specifically defined collateral at any time. For these and other reasons, the bank must retain local lawyers who are thoroughly familiar with that country’s laws, regulations, and practices and who will check loan agreements, guarantees, debt instruments, drafts, corporate resolutions, and other loan documentation. There are

significant differences between loan agreements drawn in the United States and those drawn abroad. Nevertheless, the bank must ensure that its loan agreements with borrowers protect it adequately. Generally, few restrictive covenants are required for international loans because of competition in offshore markets and differing local practices. Nevertheless, the bank should insist on protective covenants when appropriate, especially if the borrowers are small or medium-sized obligors. The bank also should ensure that loan agreements provide for the borrower to reimburse the lender for certain unanticipated costs, including the imposition of taxes on interest withheld at the source without corresponding credits gained on the levy of U.S. taxes and the need to establish or increase bad debt reserves.

Financial information. Current and complete financial information is necessary at the inception and throughout the term of an international loan. The lending policy should specifically define financial-statement requirements for businesses, foreign banks, foreign governments, other foreign public-sector entities, and individuals, and it should include criteria for the requirement of audited, nonaudited, fiscal, interim, operating, cash-flow, and other statements. The requirements should be defined clearly enough so that any credit data exception in the examination report is a clear exception to the bank’s lending policy.

The reliability of financial statements and accompanying information differs greatly among countries. In some countries, accounting standards and traditions are lax and audited statements are virtually unknown. Financial information provided for tax-collection purposes in foreign countries may differ from that given in confidence to the bank to obtain credit.

In analyzing financial statements of foreign entities, factors are present that do not exist when analyzing those of U.S. enterprises, such as markedly different accounting concepts, the wide use of “hidden reserves,” translation problems, different methods of valuing assets, or unfamiliar and sharply different legal principles. A general rule in analyzing local currency statements is not to translate figures to U.S. dollar equivalents. Fluctuating exchange rates can have a significant impact on the analysis of U.S. dollar equivalents over a period of time. If a loan is to be repaid in currency other than the borrower’s domestic currency, an analysis of

probable future foreign-exchange-rate movements is necessary to assess the borrower's ability to generate sufficient local currency to buy the necessary exchange. An analysis of the availability of exchange is also required to ensure full repayment at maturity. Financial Accounting Standards Board Statement No. 52, "Foreign-Currency Translation," takes certain translation adjustments out of earnings and places them in a separate component of equity capital ("foreign-currency translation adjustments"), thereby reducing the fluctuations in earnings produced by changing exchange rates. Since the financial information provided is not always reliable, the bank's policies should enable it to determine by other means the capacity, integrity, experience, and reputation of the foreign borrower.

Extensions of credit to foreign banks constitute an important segment of an international division's foreign loans. It is important to obtain information on the nature of the bank's business; its assets, liabilities, and contingent accounts; and its record of past earnings. A review of these data should lead to a determination of the strength of the bank and its ability to meet its obligations in the foreseeable future. At minimum, this review should include—

- the size and liquidity of primary and secondary reserves;
- the nature of lending activities, including types and terms of loans, extent of collateral held, and loss experience;
- lending policies and controls in effect to ensure compliance with applicable lending laws and regulations;
- the size and character of investments;
- the size of fixed assets;
- the size and nature of investments in subsidiaries and other affiliates and the extent to which the bank will support those entities in times of difficulty;
- the source and nature of deposits and their volatility;
- the nature and extent of other liabilities and contingent liabilities, including standby facilities;
- the earnings and dividend record and the adequacy of capital;
- the activities of the bank in the foreign-exchange and interbank markets;
- the size and character of the bank's international business; and
- the competency of management.

The quality of management is the key to the analysis of foreign banks and is best determined by frequent visits by officers of the lending bank. Credit checks from other lenders should be required with periodic updates. Credit reports are not available in all countries and, when provided, are often incomplete or vague. Consequently, there is no substitute for firsthand information obtained from visits to overseas banks.

Country risk. Balance of payments; exchange control; and economic, political, and social information on each borrower's home country should be on file to enable the bank to assess the elements of country risk. The lack of this information is as serious a weakness as the lack of financial information on the borrowers. For additional information, see section 7040, "International—Transfer Risk."

Limits and guidelines for purchasing loans. Purchasing loans from dealers or correspondent banks is a common practice in banks with limited opportunities to generate international credit extensions on their own. However, these purchases may restrict a bank to low-profit loans at narrow spreads over a medium-to-long-term period. Buying loans seldom builds relationships with borrowers since the relationship generally stays with the bank originating the loan. Therefore, the lending policy should limit the amount of paper purchased from any one outside source and should state an aggregate limit on all these loans.

Limitation on aggregate outstanding loans. Limitations on the total amount of loans outstanding relative to other balance-sheet accounts should be established for the bank, with limits (or sublimits) applicable to international loans clearly defined. Controls over the international loan portfolio are usually expressed relative to deposits, capital structure, or total assets.

Concentration of credits. The same types of concentrations of credits found in a domestic loan portfolio may exist in the international portfolio. In international banking, however, an additional concentration involves loans to a foreign government, its agencies, and its majority-owned or -controlled entities. Loans to specific private businesses may be included in those concentrations if an interrelationship exists in the form of guarantees, moral commitments,

significant subsidies, or other factors indicating dependence on the government. The bank's directorate should evaluate the risks involved in various concentrations and determine those concentrations that should be avoided or limited. The lending policy should also require that all concentrations in the international division be reviewed and reported frequently. For a full discussion of this component, see section 2050, "Concentrations of Credits."

Loan authority. The lending policy should establish written limits for all international lending officers. Lending limits also may be established for group authority, allowing a combination of officers or a committee to approve loans larger than those the members would be permitted to approve individually. The reporting procedures and the frequency of committee meetings should be defined. If the bank operates foreign branches, head office-delegated lending authority should be clearly defined and understood by overseas lending officers.

Nonperforming credits and charge-offs. The lending policy should define nonperforming credit extensions of all types (delinquencies, nonaccruals, or reduced rates) and should specify their accounting and reporting requirements. Reports should be submitted regularly to the board of directors and senior management. The management of banks with overseas branches must take extra care to define and communicate their banks' policies and procedures on nonperforming credits to ensure that all bank offices are properly identifying, accounting for, and reporting credits. The reports should include sufficient detail to allow for the determination of risk factors, loss potentials, and alternative courses of action to effect repayment of nonperforming credits. The policy governing delinquent credits should require a follow-up notice procedure that

is systematic and progressively stronger. Guidelines should be established to ensure that all accounts are presented to and reviewed by senior management or the directorate for potential charge-off at a stated period of delinquency.

Other. The lending policy should be supplemented with other written guidelines for specific departments concerned with credit extensions, such as letters of credit, banker's acceptances, and discounted trade bills. Written policies and procedures approved and enforced in those departments should be referenced in the general lending policy of the bank.

Before a bank grants international credit, its objectives, policies, and practices must be clearly established. The bank must consider its overall size, financial resources, the nature of its customers, its geographic location, and the qualifications and skills of its staff. An examiner should review policies and practices to determine if they are clearly defined and adequate to monitor the condition of the portfolio. If written guidelines do not exist, there is a major deficiency in the lending area, and the board of directors is not properly discharging its duties and responsibilities. If no exception is taken to the objectives, policies, and practices, the international loan portfolio can then be reviewed to ensure compliance.

The failure of the directors to establish a sound international lending policy, of the management to establish adequate written procedures, or of both to monitor and administer the international lending function within established guidelines has resulted in serious problems for banks. Major sources and causes of loan trouble, as discussed in domestic "Loan Portfolio Management," section 2040, also apply to international lending.

International—Loan Portfolio Management

Examination Objectives

Effective date May 1996

Section 7020.2

1. To determine if policies, practices, procedures, and internal controls for international loan portfolio management are adequate.
2. To determine if bank officers are operating in conformance with the established bank guidelines.
3. To determine the scope and adequacy of the audit function as it relates to international lending procedures.
4. To determine the overall quality of the international loan portfolio and how that quality affects the soundness of the bank.
5. To prepare information on the bank's lending function in a concise, reportable format.
6. To determine compliance with applicable laws and regulations.
7. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws and regulations are cited.

International—Loan Portfolio Management

Examination Procedures

Effective date March 1984

Section 7020.3

1. If selected for implementation, complete or update the International Loan Portfolio Management section of the Internal Control Questionnaire.
2. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examining procedures. Also obtain a listing of any deficiencies noted in the latest review done by internal and external auditors from the examiner assigned to the audit review and determine if appropriate corrections have been made.
3. Request reports on the following from the bank's international division, by department, as of the examination date unless otherwise specified:
 - a. Past-due loans. This report should cover:
 - Single payment and demand notes past due.
 - Single payment and demand notes on which interest is due and unpaid for 30 days or more.
 - Consumer, mortgage and term loans payable in regular installments on which one installment is due and unpaid for 30 days or more.
 - Outstandings under cancelled advance (overdraft) facilities that are unpaid.
 - Discounted (purchased) outgoing foreign bills matured and unpaid and advances secured by pledged delinquent foreign bills.
 - Unauthorized overdrafts including any resulting from customers not paying the bank for banker's acceptances or drafts it paid.And should include the following information:
 - Name of the obligor.
 - Original amount of the loan.
 - Outstanding balance of the loan.
 - Date the loan was made.
 - Due date.
 - Terms of the loan.
 - Number of payments the loan is delinquent.
 - Date of the borrower's last payment.
 - Date to which interest is paid.For larger international loans, the report should also include:
 - Purpose of the loan.
 - Any action being taken to bring the loan current.
 - b. International loans on which interest is not being collected in accordance with the terms of the loan.
 - c. International loans the terms of which have been modified by a reduction of interest rate or principal payment or by a deferral of interest or principal.
 - d. International loans for which repayment terms have been restructured.
 - e. International loan participations purchased and sold and participations in consortium credits since the previous examination.
 - f. International loans sold in full since the previous examination.
 - g. International credits considered "problem credits" by management (this report may be either as of the examination date or as of the date the report was last submitted to the officer's loan review committee(s), the loan and discount committee(s), or the board of directors).
 - h. International credit commitments and other contingent liabilities.
 - i. Loans secured by stock of other banks and rights, interest, or powers of a savings and loan association.
 - j. Extensions of credit to employees, officers, directors, or their interests.
 - k. Extensions of credit to executive officers, directors, principal shareholders and their interests of correspondent banks.
 - l. Miscellaneous loan debit and credit suspense accounts.
 - m. Current interest rate structure.
 - n. Current lending authorities of officers and credit committee(s).
4. Obtain the following information:
 - a. A copy of written policies covering all international lending functions.
 - b. A statement of whether a standing committee administers the lending function.
 - c. Copies of reports furnished to the board of directors for its meetings.
 - d. Lists of directors, executive officers, principal shareholders and their interests.
 - e. A summary of the officer borrowing report (debts to own and other banks).

- f. A list of previously charged-off loans approved by the directors.
5. Obtain a copy of the latest reports furnished to the international loan and discount committee(s). (The domestic loan and discount committee(s) sometimes handle(s) international loans and discounts.)
6. Review international lending policies and updates and abstract appropriate excerpts on:
 - a. Distribution of loans by category.
 - b. Geographic area and country exposure limitations.
 - c. Type of borrowing and industrial concentration limitations.
 - d. Lending authorities of committees and officers.
 - e. Any prohibited types of international loans.
 - f. Maximum maturities for various types of international loans.
 - g. Interest rate structure.
 - h. Minimum downpayment for various types of loans.
 - i. Collateral appraisal policies including:
 - Persons authorized to perform appraisals.
 - Lending values of various types of assets.
 - j. Financial information requirements by types of loans.
 - k. Guidelines for purchasing other banker's acceptances and commercial paper.
 - l. Guidelines for loans to major shareholders, directors, officers, or their interests.
7. When more than one international lending policy exists, determine if they are internally consistent by reviewing the guidelines previously obtained.
8. Review minutes of the bank's international loan and discount committee(s) meetings to obtain:
 - a. Present members and their attendance record.
 - b. Scope of work performed.
 - c. Any information considered useful in the examination of specific loan categories or other areas of the bank.
9. Compare reports furnished to the board of directors and the loan and discount committee(s), and those received from the bank in step 3 to determine any material differences and that the differences are transmitted to the board in a timely manner.
10. Compare the lists of directors, officers and their related interests to determine:
 - a. Preliminary compliance with Regulation O (12 CFR 215) (loans to insiders).
 - b. Preliminary compliance with established policies.
11. Perform the following steps for past-due loans:
 - a. Compare the following to determine any material inconsistencies:
 - The past-due schedule received in step 3. Delinquency reports submitted to the board.
 - List of loans considered "problem" loans by management.
 - b. Scan the delinquency lists submitted to the board of directors and senior management to determine that reports are sufficiently detailed to evaluate risk factors.
 - c. Compile current aggregate totals of past-due paper.
12. Perform the following using the loan commitments and contingent schedules obtained in step 3:
 - a. Reconcile appropriate contingency totals to memoranda ledger controls.
 - b. Review reconciling items for reasonableness.
13. Obtain the listing of Uniform Review of Shared National Credits and update the listing based on information obtained in step 3.
14. Obtain the classifications and categories of strong, moderately strong, and weak countries from Interagency Country Exposure Review Committee meeting for which write-ups have been made available and update that data based on information obtained in step 3.
15. Distribute the applicable schedules and other information obtained in the preceding steps to the examiners performing the loan examination programs. Request that the examiners test the accuracy of the information. Also, request that they perform appropriate steps in the separate program "Concentration of Credits."
16. Determine the general distribution and characteristics of the international loan portfolio by:
 - a. Determining the percentage of total loans in specific classes and geographic areas.
 - b. Comparing international loan category distributions to policy guidelines.

17. Obtain the results of the reviews performed of the various segments of the international division during the course of the examination, and perform the following:
 - a. Determine any nonadherence to internally established policies, practices, procedures, and controls.
 - b. Compare the various international division results to determine the extent of nonadherence and if it is systemwide.
 - c. Organize internal guideline exceptions in order of relative importance.
 - d. Determine the aggregate amount of statutory bad debts.
 - e. Organize violations by law and regulation.
 - f. Review international credit classifications and assets listed for special mention to determine:
 - Inclusion of all necessary information.
 - Substantiation of classification or criticism.
 - g. Determine the aggregate amount of credit extensions listed in each of the four levels of criticism.
 - h. Compile a listing of all credit extensions not supported by current and satisfactory credit information.
 - i. Compile a listing of all credit extensions not supported by complete collateral documentation.
 - j. Review the separate procedures for “Concentration of Credits” and determine:
 - If all necessary data is included.
 - If there is substantiation for including specific items in the report of examination as a concentration.
 - If the concentration is undue or unwarranted.
 - k. Compute the following ratios and compare to computations from prior examinations:
 - Aggregate international division past due paper to international division loans and overdrafts outstanding.
 - Aggregate international division “A” paper to international division past due.
 - Total international division past due, nonaccrual and renegotiated rate credits to total international division credits.
 - Aggregate classified international credits to primary capital funds.
 - Aggregate classified international credit to total bank classified credits.
 - Weighted classified international credits to primary capital funds.
18. Forward the totals of international division loss and doubtful classifications to the examiner assigned to analyze the adequacy of the bank’s capital.
19. Compare management’s list of “problem” credits from step 3 to the examiner’s listing of international classified and criticized credits to determine the extent of management’s knowledge of its own international credit problems.
20. Determine, through an in-depth analysis of information previously generated, the causes of existing problems or weaknesses within the international division’s systems which present potential for future problems.
21. Forward the following information to the examiner assigned to analyze the bank’s loan loss reserves.
 - a. A listing of international division credits considered “problem” credits by management.
 - b. A listing of classified and criticized credits relating to the international division.
 - c. A listing of previously charged-off loans.
22. Organize the results of the examination of the international lending function to facilitate discussion with the examiner-in-charge and, upon approval, with senior management of the bank.
23. During discussion with senior management, structure inquiries in such a manner as to:
 - a. Gain insight into management’s international lending philosophy.
 - b. Elicit management responses for correction of deficiencies.
24. Write, in appropriate report format, general remarks which may include:
 - a. The scope of the examination of the international lending function.
 - b. The quality of internal policies, practices, procedures, and controls over the international lending function.
 - c. The general level of adherence to internal policies, practices, procedures, and controls that govern the bank’s international lending function.
 - d. The scope and adequacy of the internal loan review system regarding international credit extensions.
 - e. The quality of the entire international credit portfolio.

- f. The competency of management with respect to the international lending function.
 - g. Causes of existing credit problems.
 - h. Expectations for continued sound international lending and correction of existing credit control and quality deficiencies.
 - i. Promises made by management for correction of credit control and quality deficiencies.
 - j. Credit extensions to insiders and their interests.
- 25. Compile or prepare all information which provides substantiation for your general remarks.
 - 26. Update the workpapers with any information that will facilitate future examinations.

International—Loan Portfolio Management

Internal Control Questionnaire

Effective date June 1985

Section 7020.4

Review the bank's internal controls, policies, practices, and procedures for managing the bank's loan portfolio. The bank's system should be documented in a complete and concise manner and include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information.

1. Has the board of directors, consistent with its duties and responsibilities, adopted written international loan portfolio management objectives and policies that:
 - a. Establish suggested guidelines for distribution of international loans by different categories?
 - b. Establish geographic area limits for credits?
 - c. Establish suggested guidelines for aggregate outstanding international loans in relation to other balance sheet categories?
 - d. Establish international loan authority of committees and individual lending officers?
 - e. Define acceptable types of international loans?
 - f. Establish maximum maturities for various types of international loans?
 - g. Establish international loan pricing?
 - h. Establish appraisal policy?
 - i. Establish minimum financial information required at inception of the credits?
 - j. Establish limits and guidelines for purchasing paper?
 - k. Establish guidelines for loans to bank directors, officers, and their related interests?
 - l. Establish collection procedures?
 - m. Define the duties and responsibilities of international loan officers and loan committees?
 - n. Outline international loan portfolio management objectives that acknowledge:
 - Concentrations of credit within specific industries and relating to country credits?
 - The need to employ personnel with specialized knowledge and experience?
 - Possible conflicts of interest?
2. Are international loan portfolio management objectives and policies reviewed at least annually to determine if they are compatible with changing market conditions?
3. Are the following reported to the board of directors or its designated committees (indicate which) at their regular meetings (at least monthly):
 - a. Past-due single payment loans (if so, indicate the minimum days past due for them to be included _____)?
 - b. Loans on which interest only is past due (if so, indicate the minimum days past due for them to be included _____)?
 - c. Term loans on which one installment is past due (if so, indicate the minimum days past due for them to be included _____)?
 - d. Outstandings under overdraft facilities that are unpaid (if so, indicate the minimum days past due for them to be included _____)?
 - e. Discounted (purchased) outgoing foreign bills matured and unpaid (or advances collateralized by pledged delinquent foreign bills) (if so, indicate the minimum days past due for them to be included _____)?
 - f. Overdrafts resulting from a customer not paying the bank for banker's acceptances or drafts the bank paid (if so, indicate minimum days past due for them to be included _____)?
 - g. Total outstanding international loan commitments?
 - h. Loans requiring special attention?
 - i. New loans and loan renewals or restructured loans?
4. Are reports submitted to the board or its committees rechecked by a designated person for possible omissions prior to their submission?
5. Are written applications required for all international loans?
6. Does the bank maintain credit files for all international borrowers?
7. Does the credit file contain information on:
 - a. The purpose of the loan?
 - b. The planned repayment schedule?
 - c. The disposition of loan proceeds?

- d. The points to be raised regarding the borrower from which to base questions during officer calling programs?
- e. Lending officer calls on customers and foreign countries?
8. Does the bank require periodic submission of financial statements by all international division borrowers whose loans are not fully secured by readily marketable collateral?
9. Is a tickler file maintained to assure that current financial information is requested and received?
10. Does the bank require submission of certified financial statements based on dollar amount of commitment (if so, state the dollar or equivalent minimum \$_____)?
11. Are financial statements of foreign borrowers spread in the credit file by local currency and U.S. dollar equivalents, if appropriate, on a yearly comparative basis?
12. Are borrower financial statements spread with those of comparable borrowers in the same country?
13. Does the bank perform a credit investigation on proposed and existing borrowers for new loan applications?
14. Does the bank have a periodic lending officer call program for:
 - a. Customers?
 - b. Countries?
15. Is it required that all international loan commitments be in writing?
16. Are international lines of credit reviewed and updated at least annually?
17. Are borrower's outstanding liabilities checked to appropriate lines of credit prior to granting additional advances?
18. Is there an internal review system (it may be a function of the internal audit department) which covers each department and:
 - a. Rechecks interest, discounts, fees, commissions, and maturity date computations?
 - b. Re-examines debt instruments for proper execution, receipt of all required supporting papers, and proper disclosure forms?
 - c. Determines that international loan approvals are within the limits of the bank's lending authorities?
 - d. Determines that international loans outstanding and committed are within the bank's foreign country or foreign currency limits?
- e. Determines that notes and debt instruments are being approved initially by the loan officer?
- f. Ascertains that new international loans are within the limitations set for the borrower by corporate resolution?
- g. Rechecks liability ledgers to determine that new loans have been accurately posted?
- h. Rechecks the preparation of maturity and interest notices?
- i. Examines entries to various general ledger loan controls?
- j. Confirms collateral, loans, and discounts with customers on a test basis?
19. Does the bank have an international loan review section or the equivalent?
20. Is the loan review section independent of the international lending function?
21. Are the initial results of the international loan review process submitted to a person or committee which is also independent of the international lending function?
22. Are all international loans exceeding a certain dollar amount selected for review?
23. Do international lending officers recommend loans for review?
24. Is a method, other than those detailed in steps 23 or 24, used to select international loans for review (if so, provide details)?
25. Are internal reviews conducted at least annually for all international lending areas?
26. In an officer identification system, are guidelines in effect which define the consequences of an officer withholding a loan from the review process?
27. Is the bank's international problem loan list periodically updated by the lending officers?
28. Does the bank maintain a list of international loans reviewed, indicating the date of the review and the credit rating?
29. Does the loan review section prepare summaries to substantiate credit ratings, including pass loans?
30. Are loan review summaries maintained in a central location or in appropriate credit files?
31. Are followup procedures in effect for internally classified international loans, including an update memorandum to the appropriate credit file?
32. Are officers and employees prohibited from holding blank signed notes and other debt

- instruments in anticipation of future borrowings?
33. Are paid and renewed notes cancelled and promptly returned to customers?
 34. Do loan proceeds disbursed in cash require a customer receipt?
 35. Are international loan records retained in accordance with record retention policy and legal requirements?
 36. Are new notes microfilmed daily?
 37. Is a systematic and progressively stronger follow-up notice procedure utilized for delinquent loans?
 38. Does the bank maintain loan interest, discount, fee, and commission rate schedules for various types of international loans?
 39. Does the bank periodically update the above rate schedules (if so, state normal frequency _____)?
 40. Does the bank maintain records in sufficient detail to generate the following information by type of advance:
 - a. The cost of funds loaned?
 - b. The cost of servicing loans, including overhead?
 - c. The cost factor of probable losses?
 - d. The programmed profit margin?
 41. Does the international division maintain adequate and current country analysis information?
 42. Has the international division conducted studies for those industries in which it is a substantial lender?
- ## CONCLUSION
43. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
 44. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

International—Loans and Current Account Advances

Effective date May 1996

Section 7030.1

A bank's international division lends, either directly or through state entities, to U.S. importers and exporters, foreign companies, multinational corporations, foreign banks, and foreign governments. The terms of these lending activities are consistent with the purpose of the financing.

Short-term working-capital loans to commercial business enterprises commonly finance inventories or receivables arising from trade. Receivable pledges, warehouse receipts, and liens on inventory or commodities may be held as collateral. However, in certain countries, these forms of collateral are not legally recognized and, therefore, the banks must be thoroughly familiar with applicable local laws, regulations, and practices. Loans to foreign banks are usually short-term and unsecured.

Medium-term lending (one to five years) generally represents capital goods financing, shipping loans, and various specialized credits. Long-term loans (those exceeding five years) are normally used to finance extensive projects of multinational corporations, foreign governments, or foreign state entities. Government guarantees of private long-term loans are common when the project has significant importance to a national economy.

The methods of loan financing in an international division are the same as those for domestic lending. Loans in the international division may be direct or discounted. In both of these instances, the bank holds a promissory note or similar instrument evidencing indebtedness. Current account advances, however, are a category of loans unique to international banking. This method of financing is an American substitute, used by banks in the United States, for the European method of financing by overdrafts, which is also a common lending method of overseas offices of U.S. banks. Current account advances, like overdrafts, are extensions of credit in which no instrument of specific indebtedness is used; however, a signed agreement is on file stating the conditions applicable to advances made by the bank to the obligor. Other types of

international financing treated as loans include own acceptances purchased (discounted), other banker's acceptances purchased, and discounted trade acceptances.

The same credit risks apply to international division loans as to those made in domestic loan departments, with the addition of country risk, which is the primary additional component that distinguishes an international loan from a domestic loan. Country risk encompasses the entire spectrum of risks arising from the economic, social, and political environments of a foreign country and from the governmental policies structured to respond to those conditions that may have adverse consequences for the repayment of a foreign borrower's debt. More specifically, there is a risk associated with a borrower's capacity to obtain the foreign exchange required to service its cross-border debt (that is, transfer risk). An obligor may have the financial means in its domestic currency to repay its indebtedness, but nationalization, expropriation, governmental repudiation of external indebtedness, the imposition of exchange controls, or currency devaluation may preclude the lender from obtaining timely repayment. Apart from a nation's outright repudiation of external debt, these developments might not result in an uncollectible extension of credit; however, the delay in collection could adversely affect the condition of the lending bank.

This section is designed to apply to most types of loans and current account advances found in an international division. However, lending areas in many international divisions and overseas branches are often segregated into separate departments and differ substantially from international loans and current account advances. Those are discussed in separate sections of this manual: "International—Financing Foreign Receivables," "International—Banker's Acceptances," "International—Letters of Credit," and "International—Guarantees Issued," sections 7050, 7060, 7080, and 7090, respectively.

International—Loans and Current Account Advances

Examination Objectives

Effective date May 1996

Section 7030.2

1. To determine the adequacy of policies, practices, procedures, and internal controls for international loans and advances.
2. To determine if bank officers are operating in conformance with established bank guidelines.
3. To evaluate the portfolio for credit quality, collectibility, and collateral sufficiency.
4. To determine the scope and adequacy of the audit function as it relates to international lending procedures.
5. To determine compliance with applicable laws and regulations.
6. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws and regulations are cited.

International—Loans and Current Account Advances

Examination Procedures

Effective date March 1984

Section 7030.3

1. If selected for implementation, complete or update the International Lending section of the Internal Control Questionnaire.
2. Determine the scope of the examination based on the evaluation of internal controls and the work performed by internal and external auditors.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest reviews done by internal and external auditors from the examiner assigned to the audit review and determine if appropriate corrections have been made.
4. Obtain a trial balance of the customer liability records and:
 - a. Reconcile balances to department controls and the general ledger.
 - b. Review reconciling items for reasonableness.
5. Using an appropriate technique, select borrowers for examination and prepare credit line cards.
6. Obtain the following information:
 - a. Past-due, nonaccrual and reduced rate loans and advances.
 - b. Loans whose terms have been modified by a reduction in interest rate or principal payment, or by a deferral of interest or principal.
 - c. Loans transferred, either in whole or in part, to another lending institution as a result of a sale, participation or asset swap, since the previous examination.
 - d. Loans acquired from another lending institution as a result of a purchase, participation or asset swap, since the previous examination.
 - e. Loan commitments and other contingent liabilities.
 - f. Loans secured by stock of other banks, and extensions of credit to executive officers, directors, principal shareholders, and their interests of correspondent banks.
 - g. A list of correspondent banks.
 - h. Extensions of credit to major stockholders of the bank and to bank employees, officers and directors, and to their interests (specify which officers are considered executive officers).
 - i. Miscellaneous loan debit and credit suspense accounts.
 - j. Interagency Country Exposure Review Committee determinations.
 - k. Criticized Shared National Credits (applicable international division credits).
 - l. Loans considered "problem loans" by management.
 - m. Specific guidelines in the lending policy.
 - n. Current lending authorities of bank officers and credit committees.
 - o. The current interest rate lending structure of the bank.
 - p. Any useful information on international division credit extensions resulting from the review of the minutes of the loan and discount committee(s) and any other credit committee(s).
 - q. Reports on international division credit extensions furnished to the loan and discount committee(s) and any other credit committee(s).
 - r. Relevant reports furnished to the board of directors.
 - s. Loans criticized during the previous examination.
7. Review the information received and perform the following for:
 - a. Loans transferred, either in whole or in part, to or from another lending institution as a result of a participation, sale/purchase, or asset swap:
 - Participations only.
 - Test participation certificates and records and determine that the parties share in the risks and contractual payments on pro rata basis.
 - Determine that the bank exercises similar controls and procedures over loans serviced for others as for loans in its own portfolio.
 - Determine that the bank, as lead or agent in a credit, exercises similar controls and procedures over syndications and participations sold as for loans in its own portfolio.
 - Procedures pertaining to all transfers:
 - Investigate any situations where loans were transferred immediately

- prior to the date of examination to determine if any were transferred to avoid possible criticism during the examination.
- Determine whether any of the loans transferred were either nonperforming at the time of transfer or classified at the previous examination.
 - Determine that low quality loans transferred to or from the bank are properly reflected on its books at fair market value (while fair market value may be difficult to determine, it should at a minimum reflect both the rate of return being earned on such loans as well as an appropriate risk premium).
 - Determine that low quality assets transferred to the parent holding company or a nonbank affiliate are properly reflected at fair market value on the books of both the bank and its affiliate.
 - If low-quality loans were transferred to or from another lending institution for which the Federal Reserve is not the primary regulator, prepare a memorandum to be submitted to the Reserve Bank supervisory personnel. The Reserve Bank will then inform the local office of the primary Federal regulator of the other institution involved in the transfer. The memorandum should include the following information, as applicable:
 - Name of originating institution.
 - Name of receiving institution.
 - Type of transfer (i.e., participation, purchase/sale, swap).
 - Date of transfer.
 - Total number of loans transferred.
 - Total dollar amount of loans transferred.
 - Status of the loans when transferred (e.g., nonperforming, classified, etc.).
 - Any other information that would be helpful to the other regulator.
- b. Miscellaneous loan debit and credit suspense accounts:
- Discuss with management any large or old items.
 - Perform additional procedures as considered appropriate.
- c. Loan commitments and other contingent liabilities:
- Analyze the commitment or contingent liability together with the combined amounts of the current loan balance, if any.
- d. Loans criticized during the previous examination:
- Determine disposition of loans so criticized by transcribing:
 - Current balance and payment status; or,
 - Date the loan was repaid and the source of repayment.
 - Investigate any situations where all or part of the funds for the repayment came from the proceeds of another loan at the bank, or as a result of a participation, sale or swap with another lending institution.
 - If repayment was a result of a participation, sale or swap, refer to step 7a of this section for the appropriate examination procedures.
- e. Shared national credits:
- Compare the schedule of international loans and current account advances included in the Uniform Review of National Credits program to the bank's reports of international loans outstanding.
 - For each loan or advance so identified, transcribe appropriate information to line cards. No further examination procedures are necessary for these credits.
- f. Interagency Country Exposure Review Committee credits:
- Identify any loans that were selected for review that are criticized for transfer risk reasons by the Interagency Country Exposure Review Committee.
 - For each loan or advance so identified, transcribe appropriate information to line cards. No further examination procedures are necessary for these credits.
8. Transcribe or compare information from the above schedules to credit line cards, where appropriate, and indicate any past-due status.
9. Prepare credit line cards for any international loan not previously selected for review

- which, based on information derived from the above schedules, requires an in-depth review.
10. Obtain customer liability and other information on common borrowers from examiners assigned to cash items, overdrafts, and other lending areas and, together, decide who will review the borrowing relationship. Pass or retain complete credit line cards.
 11. Prepare collateral line cards for all borrowers selected in the preceding steps.
 12. Obtain credit files for all borrowers for whom examiner credit line cards were prepared and complete credit line cards, where appropriate. To analyze the international loans, perform the following procedures:
 - a. Analyze balance sheets and profit and loss figures as shown in current and preceding financial statements and determine the existence of any favorable or adverse trends or ratios.
 - b. Review components of the balance sheet as shown in the current financial statements and determine the reasonableness of each item as it relates to the total financial structure of the borrower.
 - c. Review supporting information for the major balance sheet items and the techniques used in consolidation and determine the primary sources of repayment and evaluate the adequacy of those sources.
 - d. Ascertain compliance with provisions of credit agreements.
 - e. Review digest of officers' memoranda, mercantile reports, credit checks, and correspondence to determine the existence of any problems which might deter the contractual repayment program(s) of the borrower's indebtedness.
 - f. Relate collateral values to outstanding debt and determine when the collateral was last appraised.
 - g. Compare interest rates charged with the current interest rate schedule of the bank and determine that the terms are within established guidelines.
 - h. Compare the original amount(s) of the customer's obligations to the bank with the lending officer's authority.
 - i. Analyze secondary support afforded by guarantors and endorsers.
 - j. Ascertain compliance with the bank's established international loan policy.
 13. For loans selected for review check central liability file for borrowers indebted above the cutoff line or for borrowers displaying credit weakness or suspected of having additional liability in other lending areas.
 14. Transcribe significant liability and other information on officers, principals, and affiliations of borrowers selected for review. Cross-reference line cards to borrowers, where appropriate.
 15. Determine compliance with laws and regulations pertaining to international lending by performing the following steps for:
 - a. *Lending Limits*:
 - Determine the bank's lending limit as prescribed by state law.
 - Determine advances or combinations of advances with aggregate balances above the limit, if any.
 - b. *Section 23A, Federal Reserve Act (12 USC 371(c))—Loans to Affiliates*:
 - Obtain a listing of loans to affiliates.
 - Test check the listing against the bank's customer liability records to determine its accuracy and completeness.
 - Ensure that loans to affiliates do not exceed limits of section 23A.
 - Ensure that loans to affiliates meet the collateral requirements of section 23A.
 - Determine that low-quality loans have not been purchased from an affiliate.
 - Determine that all transactions with affiliates are on terms and conditions that are consistent with safe and sound banking practices.
 - c. *18 USC 215—Commission or Gift for Procuring Loan*:
 - While examining the international lending function, determine the existence of any possible cases in which a bank officer, director, employee, agent, or attorney may have received anything of value for procuring or endeavoring to procure any extension of credit.
 - Investigate any such suspected instances.
 - d. *Federal Election Campaign Act (2 USC 441b)—Political Contributions and Loans*:
 - While examining the international lending area, determine the existence of any loans in connection with any political campaigns.
 - Review each such credit to determine whether it is made in accordance with

applicable banking laws and in the ordinary course of business.

e. *Regulation Y (12 CFR 225)—Tie-in Provisions:*

- While reviewing international credit and collateral files, especially loan agreements, determine whether any extension of credit is conditioned upon:
 - Obtaining or providing any additional credit, property, or service from or to the bank or its holding company other than a loan, discount, deposit, or trust service.
 - The customer not obtaining a credit, property, or service from a competitor of the bank or its holding company (or a subsidiary of its holding company), other than a reasonable condition to assure the soundness of the credit.

f. *Insider lending activities.* The examination procedures for checking compliance with the relevant law and regulation covering insider lending activities and reporting requirements are as follows (the examiner should refer to the appropriate sections of the statutes for specific definitions, lending limitations, reporting requirements, and conditions indicating preferential treatment):

1. *Regulation O (12 CFR 215)—Loans to Executive Officers, Directors, Principal Shareholders, and Their Interests:*

- While reviewing information relating to insiders received from the bank or appropriate examiner (including loan participations, loans purchased and sold, and loan swaps):
 - Test the accuracy and completeness of information about international loans by comparing it to the trial balance or loans sampled.
 - Review credit files on insider loans to determine that required information is available.
 - Determine that loans to insiders do not contain terms more favorable than those afforded other borrowers.
 - Determine that loans to insiders do not involve more than normal risk of repayment or

present other unfavorable features.

- Determine that loans to insiders, as defined by the various sections of Regulation O, do not exceed the lending limits imposed by those sections.
- If prior approval by the bank's board was required for a loan to an insider, determine that such approval was obtained.
- Determine compliance with the various reporting requirements for insider loans.
- Determine that the bank has made provisions to comply with the disclosure requirements for insider loans.
- Determine that the bank maintains records of public disclosure requests and the disposition of the requests for a period of two years.

2. *Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (P.L. 95-630)—Loans to Executive Officers, Directors, and Principal Shareholders of Correspondent Banks:*

- Obtain from or request the examiners reviewing "Due from Banks" and "Deposit Accounts" to verify a list of correspondent banks provided by bank management, and ascertain the profitability of those relationships.
- Determine that loans to insiders of correspondent banks are not made on preferential terms, and that no conflict of interest appears to exist.

g. *12 USC 1730—Loans Secured by Bank Stock:*

- While examining international loans, determine the existence of any loans secured or to be secured by 25 percent or more of the outstanding voting stock or rights of an insured financial institution.
- In each such case, determine that the chief executive officer has promptly reported such fact to the proper regulatory authority.

h. *12 USC 83 (Rev. Stat. 5201) Made Applicable to State Member Banks by Sec-*

tion 9, Paragraph 6 of the Federal Reserve Act (12 USC 324)—Loans Secured by Own Stock (See also FRRS 3–1505):

- While examining international loans, determine the existence of any loans secured by the bank's own shares or capital notes and debentures.
 - Confer with the examiner assigned "Investment Securities" to determine whether the bank owns any of its own shares or its own notes and debentures.
 - In each case in which such collateral or ownership exists, determine whether the collateral or ownership was taken to prevent a loss on a debt previously contracted (DPC) transaction.
 - In each case of ownership, determine whether the shares or subordinated notes and debentures have been held for a period of not more than six months.
- i. *Regulation U (12 CFR 221):* While reviewing credit files, check the following for all loans that are secured directly or indirectly by margin stock and were extended for the purpose of buying or carrying margin stock:
- Except for credits specifically exempted under Regulation U, determine that the required Form FR U-1 has been executed for each credit by the customer, and signed and accepted by a duly authorized officer of the bank acting in good faith.
 - Determine that the bank has not extended more than the maximum loan value of the collateral securing such credits, as set by section 221.8 of Regulation U, and that the margin requirements are being maintained.
 - Determine compliance with other specific exceptions and restrictions of the regulation as they relate to the credits reviewed.
- j. *Regulation K (12 CFR 211) and Regulation Y (12 CFR 225)—International Banking Operations:*
- Review all applicable sections, especially those concerned with:
 - Loans or extensions of credit to foreign banks.
 - Loans to executive officers of foreign branches of state member banks.
 - Statement of policy or availability of information to facilitate supervision of foreign operations.
 - Reporting and disclosure of international assets and accounting for fees on international loans.
- k. *Financial Recordkeeping and Reporting of Currency and Foreign Transactions (31 CFR 103)—Retention of Credit Files:*
- Review the operating procedures and credit file documentation and determine if the bank retains records of each extension of credit over \$5,000, specifying the name and address of the borrower, the amount of the credit, the nature and purpose of the loan, and the date thereof. (Loans secured by an interest in real property are exempt.)
- l. *12 CFR 400–402—Export-Import Bank of the United States:*
- Review extensions of credit to determine compliance with Eximbank regulations as they relate to direct lending programs, cooperative financing facilities, private export funding, exporter credit programs, medium-term export debt obligations, leasing and direct discount programs.
- m. *7 CFR 1400–1499—Commodity Credit Corporation:*
- Determine compliance of international loans relating to Commodity Credit Corporations programs.
- n. *22 CFR 200–299—Agency for International Development:*
- Review to determine compliance of international loans related to Agency for International Development programs.
- o. *Section 909—International Lending Supervision Act:* Section 909 of the International Lending Supervision Act of 1983 (Act) requires that FDIC-insured banks and Edge and agreement corporations prepare a written economic feasibility evaluation for any proposed extension of credit by a U.S. banking institution or institutions which individually or when aggregated with credits of other U.S. banking institutions exceeds \$20 million per project, to finance the construction or operation of any mining operation, any metal or mineral primary processing operation, any metal fabricating facility or operation, or any metal-

making (semi and finished) operation located outside the United States. The act stipulates that the evaluation shall consider the profit potential, the competitive and economic impact of the project and the reasonable expectation of repayment. The act also mandates that any new evaluations be reviewed by federal examiners in the context of every examination.

The following check list should be used to test compliance with the requirements of the act:

- Does the banking institution have a written economic feasibility evaluation for all credit extensions by that banking institution alone or in conjunction with other U.S. banking institutions that individually, or when aggregated with credits of other U.S. banking institutions exceed \$20 million per project to finance any of the designated projects?
 - Is the evaluation signed by a senior officer of the examined or the lead U.S. banking institution?
 - Does the evaluation consider the following:
 - profit potential of the project;
 - impact of the project on world markets;
 - inherent competitive advantages and disadvantages of the project over the entire life of the project;
 - the likely effect of the project upon the overall long-term economic development of the country in which located;
 - the reasonable expectation of repayment from revenues generated by such project without regard to any subsidy provided by the government involved or any instrumentality of any country?
- Although the bank's evaluation should be done in a professional manner, examiners need not verify its accuracy. However, any negative responses to the foregoing questions would be indicative of noncompliance with the statute and should be discussed with the appropriate level of bank management. Any apparent violations should be cited in the examination report, along with a discussion of any remedial actions taken by bank management during the examination.
16. Perform appropriate steps in the Concentration of Credits section.
 17. Discuss with appropriate officers and prepare summaries in appropriate report form of:
 - a. Delinquent loans, segregating those considered "A" paper.
 - b. Violations of laws and regulations.
 - c. Loans not supported by current and complete financial information.
 - d. Loans on which collateral documentation is deficient.
 - e. Concentrations of credit.
 - f. Criticized loans.
 - g. Inadequately collateralized loans.
 - h. Extensions of credit to major shareholders, employees, officers, directors, and their related interests.
 - i. Loans which for any other reason are questionable as to ultimate collection.
 - j. Other matters regarding the condition of the department.
 18. Provide details of classified international participation loans which are not covered by the shared national credit program. Include the names and addresses of all participating state member banks and copies of the criticized loan comments.
 19. Provide the examiner-in-charge with your findings with respect to:
 - a. The adequacy of written policies relating to international loans.
 - b. The manner in which bank officers are operating in conformance with established policy.
 - c. Adverse trends within the international lending function.
 - d. The accuracy and completeness of the schedules obtained from International—Loan Portfolio Management.
 - e. Internal control deficiencies or exceptions.
 - f. Recommended corrective action when policies, practices, or procedures are deficient.
 - g. The competency of management of the international lending function.
 - h. Other matters of significance.
 20. Update the workpapers with any information that will facilitate future examinations.

International—Loans and Current Account Advances

Internal Control Questionnaire

Effective date March 1984

Section 7030.4

Review the bank's internal controls, policies, practices, and procedures for granting and servicing international loans. The bank's system should be documented in a complete and concise manner and include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written international loan policies that:
 - a. Establish procedures for reviewing international loan applications?
 - b. Define qualified borrowers?
 - c. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
2. Are international loan policies reviewed at least annually to determine if they are compatible with changing market conditions?

RECORDS

- *3. Is the preparation and posting of subsidiary international loan records performed or reviewed by persons who do not also:
 - a. Issue official checks or drafts?
 - b. Handle cash?
- *4. Are the subsidiary international loan records (control totals) balanced daily with the appropriate general ledger accounts and reconciling items adequately investigated by persons who do not normally handle loans and post records?
5. Are the following properly recorded as "loans" for accounting and call report purposes:
 - a. Acceptances of other banks purchased?
 - b. Own acceptances purchased (discounted)?
 - c. Customer's liability to the bank on drafts paid under letters of credit for which the bank has not been reimbursed?

- *6. Is a loan delinquency report prepared for and reviewed by management frequently (if so, how often _____)?
- *7. Are inquiries about loan balances received and investigated by persons who do not process loans, handle settlements, or post records?
- *8. Are bookkeeping adjustments checked and approved by an appropriate officer?
9. Is a daily record maintained summarizing loan transaction details, i.e., loans granted, payments received, and interest collected, to support applicable general ledger account entries?
10. Are frequent note (or record copy) and liability trial balances prepared and reconciled monthly with control accounts by employees who do not process or record loan transactions?

INTEREST

- *11. Is the preparation and posting of interest records performed or reviewed by persons who do not also:
 - a. Issue official checks or drafts?
 - b. Handle cash?
12. Are any independent interest computations made and compared or adequately tested to initial interest records by persons who do not also:
 - a. Issue official checks or drafts?
 - b. Handle cash?

COLLATERAL

13. Are multicopy, pre-numbered records maintained that detail the complete description of collateral pledged?
14. Are the functions of receiving and releasing collateral to borrowers and of making entries in the collateral register performed by different employees?
15. Is negotiable collateral held under joint custody?
16. Are receipts obtained and filed for released collateral?
17. Are securities valued and margin requirements reviewed at least monthly?

18. When collateral support is the cash surrender value of insurance policies, is a periodic accounting received from the insurance company and maintained with the policy?
19. Is a record maintained of entry to the collateral vault?
20. Are stock powers filed separately to bar negotiability and to deter abstraction of both the security and the negotiating instrument?
21. Are securities out for transfer, exchange, etc., controlled by pre-numbered temporary vault-out tickets?
22. Are pledged deposit accounts properly coded to negate unauthorized withdrawal of funds?
23. Are acknowledgements received for pledged deposits held at other banks?
24. Is an officer's approval necessary before collateral can be released or substituted?
 - c. Determines that items released on temporary vault-out tickets are authorized and have not been outstanding for an unreasonable length of time?
 - d. Determines that loan payments are promptly posted?
28. Are all notes and advances recorded on a register or similar record and assigned consecutive numbers?
29. Are payment notices prepared and sent by someone not connected with loan processing?
30. Are any notes signed by a customer in blank and held in anticipation of future borrowings properly safeguarded?
31. Are lending officers frequently informed of maturing loans and credit lines?

OTHER

25. Are notes and advance slips safeguarded during bank hours and locked in the vault overnight?
26. Are all loan rebates approved by an officer and made only by official check?
27. Does the bank have an internal review system that:
 - a. Re-examines collateral items and supporting documentation for negotiability and proper assignment?
 - b. Test checks values assigned to collateral when the loan is made and at frequent intervals thereafter?

CONCLUSION

32. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
33. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

When banks engage in international lending, they undertake customary credit risk as denoted by the possibility of nonpayment due to an obligor's weak financial condition or a lack of adequate collateral protection. Additionally, international lending bears risks associated with conditions within a foreign borrower's home country, such as underlying economic, political, and social trends and movements. In particular, there is a risk that a borrower will be unable to convert its local currency income into the currency needed to repay the loan (that is, transfer risk). The traditional examination approach to commercial credit risk is treated separately in other sections of this manual. The purpose of this section is to delineate the current examination policies, objectives, and procedures for evaluating a bank's transfer risk exposures and its management system for monitoring and controlling these exposures.

Country or sovereign risk encompasses the entire spectrum of risks arising from the economic, social, and political environments of a foreign country that may have potential consequences for foreigners' debt and equity investments in that country. More specifically, transfer risk focuses on a borrower's capacity to obtain the foreign exchange required to service its cross-border debt.

The examination of transfer risk entails (1) the identification of selected country exposures of a bank that are considered significant relative to the bank's capital and the economic performance of the country; (2) the classifications of substandard, value-impaired, and loss; (3) a determination as to the adequacy of mandated special reserves against certain international assets classified value-impaired; (4) the segregation and analysis of those nonclassified credits into "other transfer risk problems" that warrant bank management's close attention and concentrations that warrant special comment; and (5) an in-depth assessment of the adequacy of the systems employed by the bank to monitor and control this facet of international lending. Five report pages have been designed to reflect an examiner's analysis of the transfer risk element in international lending for a particular bank as follows.

The first page, *Selected Country Exposures*, merely lists, without comments, exposures that are deemed significant in relation to a bank's capital and the economic performance of the

country. Exposures, depending on the country grouping, are taken from the bank's last quarterly Country Exposure Report, FFIEC 009, and compared to the bank's capital as of the same date.

The second page, *Classifications Due to Transfer Risk*, reflects credits classified due to transfer risk by the Interagency Country Exposure Review Committee. Totals in each classification should be carried forward to the Summary of Classified Items page, with adjustments to eliminate those credits classified due to commercial risk in accordance with the instructions in the procedures section of this manual.

In December 1983, the federal banking agencies adopted examination categories for identifying credits that have been adversely affected by transfer risk problems. In addition, the International Lending Supervision Act of 1983 requires banks to establish and maintain a special reserve when the value of international assets has been impaired by a protracted inability of the borrowers in a country to make payments on external indebtedness or no definite prospects exist for orderly restoration of debt service. Both issues are outlined in the procedures section.

The third page, *Nonclassified Credits Warranting Attention I; Other Transfer Risk Problems (OTRP)*, is used to highlight all or a portion of those credits to a country that is not complying with its external debt-service obligations, but is taking positive steps to restore debt service through economic adjustment measures, generally as part of an IMF program. While not subject to classification, exposures in this category should be considered by examiners as a judgmental factor in their general assessment of a bank's asset quality and the adequacy of its reserves and capital.

The fourth page, *Nonclassified Credits Warranting Attention II; Concentrations of Transfer Risk Warranting Special Comment*, identifies exposures as of the examination date in which a combination of the amount outstanding in relation to the bank's capital funds, the composition of the portfolio, and the economic performance of the country would warrant the bank to focus special attention on its exposure.

The fifth page, *Analysis of the Country Exposure Management System*, presents in narrative form an assessment of a bank's system for monitoring and controlling its transfer risk expo-

tures. Included are comments relative to the bank’s procedures for measuring exposure, the system for establishing country lending limits, and the bank’s capability to analyze countries. Comments on page 1 of the report of examina-

tion may range from criticisms of weaknesses in the country exposure management system to high concentrations of risk in potentially weak and/or problematic countries.

SELECTED COUNTRY EXPOSURES

1. To determine if the bank is properly preparing the Country Exposure Report (FFIEC 009), which is required to be filed quarterly with the respective Reserve Banks.
2. To identify and report individual country exposures considered significant in relation to the bank's capital and the economic performance of the country.

CLASSIFICATIONS DUE TO TRANSFER RISK

3. To evaluate the portfolio to identify those credits in countries considered subject to classification by the Interagency Country Exposure Review Committee.
4. To determine if the bank has adequately provided the required special reserves for those international assets included in the country exposures classified value-impaired.
5. To develop information on the composition of those exposures subject to classification.
6. To prepare report pages on all transfer risks subject to classification.
7. To determine the effect of total transfer risk classifications on the overall quality of the international loan portfolio, as well as that of the total bank.

NONCLASSIFIED CREDITS WARRANTING ATTENTION—OTHER TRANSFER RISK PROBLEMS

8. To identify and report any exposures to

countries identified as “other transfer risk problems.”

9. To develop information on the composition of those exposures so identified, for report page.

NONCLASSIFIED CREDITS WARRANTING ATTENTION—CONCENTRATIONS OF TRANSFER RISK WARRANTING SPECIAL COMMENT

10. To identify and report any concentrations of transfer risk warranting special comment.
11. To develop information on the composition of those concentrations for report page.

ANALYSIS OF THE COUNTRY EXPOSURE MANAGEMENT SYSTEM

12. To determine if the bank's policies, practices, procedures, and internal controls for the management of transfer risk are adequate.
13. To determine if bank officers are operating in conformance with established guidelines.
14. To prepare narrative commentary on the bank's country exposure management system and on any noted deficiencies in a concise reportable format.

International—Transfer Risk

Examination Procedures

Effective date May 2000

Section 7040.3

Transfer risk is one facet of the more broadly defined concept of *country risk*. Country risk, which has an overarching effect on the realization of an institution's foreign assets, encompasses all of the uncertainties arising from the economic, social, and political conditions in a country. It includes the possibility of deteriorating economic conditions, political and social upheaval, nationalization and expropriation of assets, government repudiation of external indebtedness, exchange controls, and currency depreciation or devaluation. *Transfer risk* focuses more on the availability of foreign exchange to service a country's external debt.

The transfer risk examination procedures emphasize diversification of exposure in relation to a bank's capital as the primary method of moderating transfer risk. Where concentrations are noted, the degree of risk inherent therein is assessed in light of the composition of the portfolio and the general economic and political factors which may affect the debt-service capacity of the individual countries.

Information concerning the relative grouping and classification of countries and appropriate comments are prepared by the Interagency Country Exposure Review Committee (ICERC) and will be furnished to examiners as required in the examination process. Since this information is sensitive, adequate safeguards should be established to ensure that it is not accessible to unauthorized personnel. The chief executive officers of those banks filing the quarterly Country Exposure Report (FFIEC 009) receive copies of the write-ups on classified countries for *only* those classifications applicable to their own bank. In no event should the complete listing of country groupings be divulged. This approach parallels that of the Shared National Credit Program.

To promote uniform and consistent application of these procedures, examiners should avoid ad hoc interpretations of the instructions and should address all questions to their respective offices. The federal banking agencies have developed a publication, "Guide to the Interagency Country Exposure Review Committee Process," to clarify and make more transparent the role of the ICERC in the supervisory process. See SR-99-35.

APPLICATION OF ICERC RATINGS

ICERC transfer risk ratings are applicable in—

- every U.S.-chartered insured commercial bank in the 50 states of the United States, the District of Columbia, Puerto Rico, and U.S. territories and possessions;
- every U.S. bank holding company, including its Edge and agreement corporations and other domestic and foreign nonbank subsidiaries; and
- the U.S. branches and agencies of foreign banks (however, the allocated transfer risk reserve (ATTR) requirement does not apply to these entities).

ICERC ratings are generally applicable to all types of foreign assets held by an institution, with the exception of premises, other real estate owned, and goodwill. For purposes of the ICERC rating, the determination of where the transfer risk for a particular exposure lies takes into consideration the existence of any guarantees, and is based on the country of residence of the ultimate obligor. See the instructions for the FFIEC 009 Country Exposure Report.

The ICERC transfer risk rating is the only rating applicable to sovereign exposures in a reviewed country (that is, direct or guaranteed obligations of the country's central government or government-owned entities). However, if they are carried on the institution's books as an investment, securities issued by a sovereign entity are also subject to the FFIEC's "Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks." The FFIEC agreement provides for specific, and possibly more severe, classification treatment of "sub-investment-quality securities." Furthermore, except as noted in the next paragraph, the ICERC transfer risk rating is also the minimum risk rating applicable to all other cross-border and cross-currency exposures of U.S. banks in a reviewed country.

Regardless of the currencies involved, to the extent that an institution's claims on local country residents are funded by liabilities to local country residents, the ICERC's transfer risk ratings do not apply. For example, to the extent

that it has liabilities to local residents (such as sterling deposits), claims of the London branch of a U.S. bank on a public or private-sector obligor in the United Kingdom (whether the claims are denominated in sterling, dollars, or marks) are not subject to the ICERC transfer risk rating.

The ICERC is not able to evaluate the credit risk associated with individual, private-sector exposures in a country. Therefore, based on an evaluation of credit-risk factors (including the effects of country risk), examiners may assign credit-risk ratings to individual, private-sector exposures that are more severe than the ICERC-assigned transfer risk rating for the country. For any given private-sector exposure, the applicable rating is *the more severe* of either the ICERC-assigned transfer risk rating for the country or the examiner-assigned credit-risk rating (including ratings assigned as a result of the Shared National Credit Program).

Questions sometimes arise concerning the consideration that examiners should give to informal expressions of support by the central government of a country for a particular borrower or sector of the economy (most often, banking). Unless they constitute a guarantee or other legally binding commitment, examiners should view such expressions of support as no more than a mitigating factor in their evaluation of the counterparty's credit risk. Informal expressions of support by the central government would not cause the counterparty's credit-risk rating to revert to the ICERC-assigned transfer risk rating for the country.

Although the ICERC may have rated ordinary short- and/or long-term exposures in a country as "OTRP," "substandard," "value impaired," or "loss," there are several special categories of exposure in a country that may receive a less severe transfer risk rating if certain conditions are met, as described below.

- *Performing short-term bank and performing short-term trade exposures.*¹ Short-term bank

1. A *performing credit* is current and has not been restructured to avoid delinquency or because of a deterioration in the financial condition of the borrower. A credit is considered "current" if it has not been reported as "past due" or "nonaccrual" for the bank call report. *Trade credit* consists of credit extensions that are directly related to imports or exports and will be liquidated through the proceeds of international trade. These credit extensions will include pre-export financing only when there is a firm export sales order and the proceeds of the order will pay off the indebtedness.

and trade exposures are generally considered to have a lower level of transfer risk because, historically, they have received priority in the allocation of a country's foreign-exchange resources. In recognition of their historical performance, the ICERC usually assigns a more favorable rating to these types of exposures.

- *Securities held in trading accounts.* Presuming that there is an active and liquid market for the securities and that the bank has procedures in place to appropriately value them, the ICERC may, on a case-by-case basis, assign a less severe transfer risk rating to specific securities held in the bank's trading account. In any case, because FASB Financial Accounting Standard No. 115 requires that they be marked to market, trading-account securities are not subject to an ATRR requirement.
- *Direct equity investments.* The ICERC may, on a case-by-case basis, assign a less severe transfer risk rating to specific direct equity investments when *all* of the following conditions are met:
 - The investment has been marked to market or is valued using the equity accounting method.
 - The institution has provided the ICERC with evidence that the foreign business is financially viable.
 - The institution has provided the ICERC with evidence of its ability to repatriate dividends, interest payments, and proceeds from the sale of assets on a timely basis.

EXAMINATION REPORT

The entire section dealing with transfer risk should be placed in an international operations section of the commercial report of examination. In addition, the discussion of transfer risk assets should be separated from all other loans and assets classified or specially mentioned elsewhere in the report.

Selected Country Exposures

A list should be presented of transfer risk exposures considered large relative to the bank's

own capital funds, after taking into account the economic, social, and political circumstances within a country. These exposures, which comprise total claims and contingencies, should be taken from the last quarterly Country Exposure Report (FFIEC 009) filed by the bank under examination and compared with consolidated bank capital as of the same date. For this purpose, capital is defined as tier 1 and tier 2, and it should be footnoted as such on this page. The examiner should also note that this report of country exposure and its comparison with bank capital may differ from actual exposure as of the date of examination. The level at which exposure is listed is based on a review of the performance of each country by the ICERC.

Examiners are encouraged to review the instructions for preparing the country exposure report for further information concerning the preparation of this page. While it is not expected that examiners review the country exposure reports filed between examinations for accuracy, a spot check to verify that such reports are being prepared properly should be made. Material reporting errors uncovered during the examination should be included in comments on reporting exceptions elsewhere in the report of examination. When bank management relies on the data generated for the country exposure report, and when reporting exceptions are noted, comments should be incorporated in the analysis of the country exposure management system.

Ratings and Classifications Due to Transfer Risk

A list of exposures subject to classification as a result of transfer risk considerations should be prepared. The decision to classify a bank's exposure to a particular country is made by the ICERC based on criteria incorporated into the provisions of the International Lending Supervision Act of 1983.

The ICERC's assessment of transfer risk reflects the committee's application of the following category definitions.

- **Strong.** The country does not experience social, economic, or political problems that could interrupt repayment of external debt.
- **Moderately strong.** The country experiences a limited number of identifiable economic, social, or political problems that do not pres-

ently threaten orderly repayment of external debt.

- **Weak.** The country experiences many economic, social, or political problems. If not reversed, these problems could threaten orderly repayment of external debt.

The ratings and classification categories, and when they are applied, are as follows.

Other Transfer Risk Problems (OTRP)

- A country is not complying with its external debt-service obligations, as evidenced by arrearages, forced restructuring, or rollovers; however, the country is taking positive actions to restore debt service through economic adjustment measures, generally as part of an International Monetary Fund (IMF) program.
- A country is meeting its debt obligations, but noncompliance appears imminent.
- Exposures to a country have been classified previously, but recent debt-service performance indicates classification is no longer warranted (for example, the country is complying with the terms of IMF and rescheduling programs). However, sustained resumption of orderly debt service needs to be demonstrated.

Substandard

- A country is not complying with its external service obligations, as evidenced by arrearages, forced restructuring, or rollovers.
- The country is not in the process of adopting an IMF or other suitable economic adjustment program, or is not adequately adhering to such a program.
- The country and its bank creditors have not negotiated a viable rescheduling and are unlikely to do so in the near future.

Value Impaired

A country has protracted arrearages, as indicated by more than one of the following:

- The country has not fully paid its interest for six months.
- The country has not complied with IMF programs (and there is no immediate prospect for compliance).

- The country has not met rescheduling terms for over one year.
- The country shows no definite prospects for an orderly restoration of debt service in the near future.

Loss

A loan is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted. An example would be an outright statement by a country which repudiates obligations to banks, the IMF, or other lenders.

The ICERC also prepares the write-ups supporting each classification. Examiners are to provide commentary on the disaggregation of each country exposure subject to classification. Include comments relative to the bank's country lending limit and any references to any proposed increases and/or decreases to such limit. The examiner's commentary is to be followed by a standardized write-up on each country for which the bank has exposures, prepared by the ICERC.

Credits Warranting Attention

Other Transfer Risk Problems (OTRP)

A listing and narrative on the bank's total exposure, or portion thereof, to a country for which the exposures were designated as OTRP should be prepared. Comments for each country will consist of a paragraph detailing the composition of the exposure, as prepared by the examiner. Following the comments will be a standardized write-up prepared by the ICERC, discussing developments in the country. When exposures to a country are split between classifications and OTRP, the standardized country write-up need be shown *only* on the classification page with a reference to such on the OTRP page.

The total of OTRP exposures should be considered by examiners as a judgmental factor in their general assessment of a bank's asset quality and the adequacy of its reserves and capital. This view is similar to consideration given to factors such as concentrations in the portfolio, the level and composition of nonaccruing or

reduced-rate assets, and management's demonstrated ability to administer and collect problem credits.

Nonclassified Credits Warranting Attention

Concentrations of Transfer Risk Warranting Special Comment

A listing and narrative on exposures to weak and moderately strong countries as of examination date and compared with the bank's capital as of that date should be prepared. When the country exposure report is filed on a consolidated bank holding company basis, the data may be used to prepare a selected country exposures page and a summary that is compared with the holding company's capital. However, examiners should attempt to segregate the bank's exposures for all other transfer risk pages. When exposures to particular countries at the holding company are deemed to be significant relative to the bank, examiners are to note such in their commentary on those countries.

Each country exposure should be listed alphabetically, accompanied by a paragraph detailing the composition of the bank's exposure. Include comments relative to the country lending limit and proposals to increase or decrease it. The examiner's commentary is to be followed by a standardized write-up, prepared by the ICERC. The criteria for determining exposures warranting comments are listed below.

Strong countries. The "strong countries" designation applies when the country does not experience social, economic, or political problems that could interrupt repayment of external debt. No exposures to strong countries will be commented on in this page. Extremely large exposures to these countries may be commented on in the discussion of the exposure-management system and the examiner's summary comments.

Moderately strong countries. The "moderately strong countries" designation applies when the country experiences a limited number of identifiable economic, social, or political problems that do not presently threaten orderly repayment of external debt. The following criteria apply; item 2 is optional.

1. Exposures exceeding 15 percent of capital must be commented on.
2. For exposures between 10 and 15 percent of capital, there is a presumption in favor of commenting if outstandings with a maturity in excess of one year exceed 7.5 percent of capital. If maturities in excess of one year are less than that amount, there will be a presumption against commenting.
3. Exposures below 10 percent will not be commented on.

Weaker countries. The “weaker countries” designation applies when the country experiences many economic, social, or political problems. If not reversed, these problems could threaten orderly repayment of external debt. The following criteria apply; item 2 is optional:

1. Exposures exceeding 10 percent of capital must receive comment.
2. For exposures between 5 and 10 percent of capital, there is a presumption in favor of commenting only if amounts due in excess of one year exceed 5 percent of capital. If amounts maturing in excess of one year are less than 5 percent, the presumption is against commenting.

When comment is optional (points (2) above), the examiner will be allowed some flexibility and may determine not to follow the presumptions if other pertinent banking factors weigh more heavily either for or against comment. These factors might be management ability, the nature of ICERC’s comment about the country, or the results of a more detailed breakdown of the composition of the portfolio. It is possible that exposures will be listed on this page with other exposures to the same country either subject to classification or listed as an other transfer risk problem. In such instances, the standardized write-up should appear on either of those pages with a cross-reference noted on this page.

RESERVING REQUIREMENTS

The agencies believe responsibility for recognizing and accounting for deterioration in the value of a bank’s assets, including a deterioration due to transfer risk problems, rests, in the first instance, with the management of a bank and its

auditors. The banking agencies also have a responsibility to ensure that banks are following reasonable and prudent policies in this regard, and that necessary adjustments are being made consistently. To ensure this, the federal banking agencies, pursuant to the International Lending Supervision Act, require U.S. banks to establish an ATRR against the risks presented in certain international assets whose value has been found by the ICERC to have been significantly impaired by protracted transfer risk problems. The ATRR should be applied to certain international assets that have been classified for transfer risk reasons as “value impaired.” The act also requires that the ATRR be established by a charge against current income, be segregated from the bank’s general allowance for possible loan losses, be deducted from gross loans and leases, and not be included as part of bank capital.

The alternative to establishing an ATRR is the direct charge-off of that portion of the international asset deemed to be of diminished value. However, if this alternative accounting treatment is used, the institution may not write up the value of the assets if the ATRR requirement is later reduced or eliminated. No ATRR provisions are required if the bank has previously written down or charged off the requisite amounts. Furthermore, no ATRR will be required on contingent liabilities. Instead, contingent liabilities to value-impaired countries will be reviewed on a case-by-case basis, but generally will be treated as OTRP.

The ATRR amounts mandated will be reviewed regularly by the Committee to determine if additional reserves are required or whether downward adjustments need to be made. Initially, special reserves would not apply to net new lending when additional loans are made in the context of an IMF or other appropriate economic adjustment program, and when the lending generally enhances the debt-service capability of the country concerned. Whether an ATRR is subsequently required for these new loans would be determined by the ICERC on the basis of performance and continued inapplicability of the established criteria.

To calculate the reserves, examiners must multiply the reserve percentage times the amount of the adjusted exposure subject to transfer risk and the ATRR. This calculation should be done on the face amount of each loan outstanding before deducting any previous write-downs. For purposes of this computation, inter-

est payments which have been applied to existing loan balances are tantamount to write-downs and are an acceptable alternative to the establishment of an ATRR. The number derived after the calculation should be netted against previous write-downs to arrive at the mandated ATRR. In accordance with SR-92-2 (FIS), February 10, 1992, the resulting net exposure, after adjusting for the ATRR, is included in the total classified “value impaired,” but is weighted like a substandard credit *only* in determining the asset quality of the bank and other measures of financial soundness. The resulting net exposure, after adjustment for the ATRR, is included in the total classified “value impaired” and is looked upon as a doubtful classification *only* in determining the asset quality of the bank and other measures of financial soundness. When a shortfall exists, management should be apprised and be expected to comply with the statute in establishing the required reserve. Comments relative to any shortfall and management’s actions should be made on page 1. Although the general rule is that all exposures rated “value impaired” are subject to the ATRR requirement, over the years there have been a number of clarifications and refinements. See 12 CFR 20, 211, and 351.

ANALYSIS OF THE COUNTRY EXPOSURE MANAGEMENT SYSTEM

Generally, all banks have systems for appraising, monitoring and controlling their foreign-lending activities. These systems differ from bank to bank in terms of the measure of the outstanding exposure, the independence of transfer risk assessments and control from marketing considerations, the capability to make country judgments on the basis of analytical factors and firsthand knowledge of the country, the centralization and formality of procedures, and the level of in-depth review. Given these variations, banks’ country exposure management systems consist of three important components.

One component is the provision for evaluation of economic trends, political developments, and the social fabric within countries where bank funds are at risk. These so-called country studies are derived from economic data supplied by the borrower or published by institutional lenders; sociopolitical commentaries; or on-site reports from bank branches, subsidiaries, or

affiliates; or through bank-officer visits to the country.

The second component involves the undertaking by the board of directors and senior management to define the level of country exposure the bank is willing to assume. This undertaking normally includes the establishment of limits on aggregate outstandings, maturities, and categories of risk exposures by country, which serve as a guide to operating management in the development and servicing of the bank’s international credit portfolio.

The third component is the bank’s internal reporting system designed to monitor and control country exposure. A comprehensive reporting system is required to accurately assign risk exposures to the country of risk, ensure adherence to the directives of the board, provide for at least an annual review of portfolio composition in individual countries, and establish a clear-cut methodology for reporting exceptions to established limits.

The country exposure management system summary sets forth guidelines and procedures to be used by examiners in evaluating systems employed by banks to monitor and control country-risk elements in international loan portfolios. In assessing the quality of the country exposure management system, examiners should, as a matter of course, spot-check the accuracy of the data submitted on the FFIEC 009. The review should include the exposures for at least several countries. Material exceptions may be subject to comment on this page. To prepare this summary, the examiner should perform the following procedures:

1. Obtain the following from a review of the minutes and reports of the board of directors:
 - a. a copy of written policies covering transfer risk
 - b. the name and composition of the committee responsible for administration of transfer risk
2. Review international lending policies and determine—
 - a. who initiates and gives final approval for country ratings and country limits;
 - b. how frequently and by whom country ratings and limits are reviewed and changed;
 - c. how the bank defines the ratings assigned to the various countries;
 - d. how country limits are determined;
 - e. who is responsible for monitoring compli-

- ance with country limits;
 - f. to what extent country limits are viewed as guidelines which may be exceeded;
 - g. if the bank has different sublimits for private- and public-sector credits;
 - h. if separate limits are established for private- and public-sector credits;
 - i. if the board of directors or a committee thereof periodically reviews country ratings and limits, and evaluates the bank's performance against those standards;
 - j. to what extent comments or classifications of bank supervisors are considered in establishing, increasing, or decreasing country limits; and
 - k. how the system has been changed since the last examination.
3. Review reports furnished to the board of the appropriate committee to ensure that comprehensive and accurate information is being submitted on a timely basis.
 4. Obtain the bank's report on the general distribution and characteristics of the international loan portfolio and compare loan category distributions for adherence to guidelines.
 5. During discussion with senior management, direct inquiries in order to—
 - a. gain insight into general management's international lending philosophy, and
 - b. elicit management responses for correction of deficiencies.

When reporting on the bank's country exposure management system, the examiner should consider such factors as—

1. the quality of internal policies, practices, procedures, and controls over the international-lending functions;
2. the scope and adequacy of the internal loan-review system as it pertains to country risk;
3. causes of existing problems;
4. commitments from management for correction of deficiencies;
5. expectations for continued sound international lending or correction of existing deficiencies;
6. the ability of management to monitor and control transfer risk;
7. the general level of adherence to internal policies, practices, procedures, and controls; and
8. the scope and adequacy of the bank's analysis of country conditions.

OTHER MATTERS

Discussion of Transfer Risk on Examiner's Comments Page

As a general rule, classifications due to transfer risk are included in the total assets classified and discussed under a major heading, such as "Asset Quality." Transfer risk classifications of any significance should be highlighted. When the bank has other exposures of concern which warrant not only senior management's special attention, but the attention of the bank's board of directors, comments may be generated under a separate caption entitled "Transfer Risks." The examiner should include comments relative to the classifications; the shortfall, if any, in the mandatory reserves against exposures considered value impaired; other transfer risk problems (OTRP); concentrations warranting special comment; and any other noted deficiency, such as an ineffective country exposure management system.

Sharing Information with State Banking Examiners

When an examination of a state member bank is being conducted concurrently and/or on a joint basis with state authorities, Federal Reserve examiners may share with state banking examiners information on those countries to which the bank under examination has exposures subject to classification and/or comment.

Country Categories

The complete listing of countries as prepared by the ICERC is highly confidential and for internal use only. In discussions with bank management, examiners should refer only to countries that will be commented upon in that bank's examination report. In this context, any reference to a "categorization" of countries should be couched in neutral terms.

Examiners are to provide the examiner-in-charge with essential information that will help facilitate future examinations. In addition, all workpapers should be maintained in an orderly manner, properly labeled, and available for inspection when and if necessary.

International—Transfer Risk

Internal Control Questionnaire

Effective date March 1984

Section 7040.4

1. Has the board of directors, consistent with its duties and responsibilities, adopted written international loan portfolio management objectives and policies that:
 - a. Establish country exposure limits for credits?
 - b. Establish limits for distribution of loans by type and maturity?
 - c. Acknowledge concentrations of credit within countries and the need to employ personnel with appropriate specialized knowledge and experience to supervise those concentrations?
2. Are international loan portfolio management objectives and policies reviewed at least annually to determine if they are compatible with changing market conditions?
3. Are significant changes in country conditions and/or levels of exposure brought to the attention of the board of directors or its designated committee promptly?
4. Are country limits revised in response to substantive changes in economic, political and social conditions within particular countries?
5. Are country limits reviewed and updated at least annually?
6. Prior to granting additional advances or commitments, are outstandings checked to appropriate country limits?
7. Are lending officers cognizant of specific country limitations?
8. Are procedures for exceeding country limits clearly defined?
9. Does the bank have a periodic foreign call program for countries?
10. Is there an internal review system which determines that international risk assets outstanding and committed are within the bank's foreign exposure limits?
11. Are country risk factors (economic, political and social) and other factors in a particular country considered in the bank's internal periodic review of its risk assets?
12. Does the bank's system for maintaining adequate and current country analysis information include:
 - a. A review of country conditions on a regular basis (state frequency and indicate who performs analyses _____)?
 - b. A continuing review of current country data obtained from internal and external sources?
 - c. An analysis of economic, political, social and other factors affecting country risk?
13. Does the bank have a formal reporting system on country risk?
14. Does the bank's country risk evaluation system accurately recognize exposure from country to country on the basis of legally binding guarantees, collateral, or reallocation by office of responsibility?
15. Does the reporting system provide complete exposure data quickly and in sufficient detail to assess particular risks?

INTRODUCTION

Financing foreign receivables, a specialized area of commercial lending in an international banking division, includes open-account financing, sales on consignment, advances against collections, discounting trade acceptances, banker's acceptances, factoring, and forfaiting. Certain foreign receivables are guaranteed or insured against cross-border risk by the Export-Import Bank of the United States, the Foreign Credit Insurance Association, and other U.S. and foreign organizations. Factoring is discussed in section 2180 of this manual, and accounts receivable financing is discussed in section 2160 (Asset-Based Lending) of this manual.

OPEN-ACCOUNT FINANCING

The simplest method of financing foreign receivables is on open account. In this type of sale, the buyer and seller agree on payment at a specified date without a negotiable instrument, such as a draft or acceptance, evidencing the obligation. In most instances, the shipping documents are sent directly to the buyer rather than through a bank. The exporter may request that the buyer make payment to the bank at which the exporter maintains an account. The advantages of an open-account sale are its simplicity, lack of bank charges, and the avoidance of stamp duties that certain countries apply to drafts.

The financing of open-account sales does have certain risks. Neither the lending bank nor the exporter have control over the shipping documents, and the buyer (importer) may take possession of the goods without the consent of the bank or exporter. In addition, if the importer does not register the goods with the proper authorities, the importer may not have access to the amount of foreign exchange necessary to pay for the imports at the time of payment. Perhaps the greatest risk in open-account financing is the lack of standard trade-financing documentation on which to base legal action against the importer in the event of default. Therefore, open-account sales are most appropriate when the buyer is a subsidiary of a related company or is well known to the seller and when the importing country has no significant economic, political, or social problems and,

consequently, is not encountering foreign-exchange difficulties.

SALES ON CONSIGNMENT

Under a consignment arrangement, goods are consigned to the importer (consignee) abroad, and the exporter (consignor) retains title to them until they are sold to a third party. However, unless the shipment is made to an exporter's overseas branch or subsidiary, the exporter's credit risk may be considerable. As with open-account sales, there is a lack of standard trade-financing documentation on which to base legal action if the consignee defaults. The exporter should thoroughly understand the inherent credit risks, especially when goods are consigned to an agent, representative, or import house abroad.

In countries with free ports or free trade zones, consigned goods may be placed under bonded warehouse control in the name of a foreign bank or branch of the bank. Arrangements may then be made to release the consigned merchandise at the time it is sold. Merchandise is cleared through customs after the sale has been completed. However, that type of consignment should not be made and will not usually be accepted by foreign banks until all pertinent conditions and regulations are verified and storage facilities are arranged. The exporter's bank also should verify that goods not sold may be returned to the country of origin. Consignment shipments financed by the bank should be limited to countries that do not have burdensome foreign-exchange restrictions and that have sufficient foreign exchange available to pay for imports.

To overcome the disadvantages of financing shipments on an open-account or consignment basis, exporters frequently ship goods against documentary collections. Consequently, the exporter, in the case of a time or arrival draft, or the exporter and the importer jointly, in the case of a sight draft, finance the shipment. The exporter and the importer may have unused credit lines with their banks and be in a position to borrow the needed money without tying the financing to the trade transaction. However, often the exporter's or the importer's regular bank lines are fully drawn down, so they may seek bank financing in the form of advances

against outward collections, discounting trade acceptances, banker's acceptances, factoring, or forfaiting.

ADVANCES AGAINST FOREIGN COLLECTIONS

A manufacturer or merchant conducting a strictly domestic business often obtains a loan from a bank, finance company, factor, or forfaiter using accounts receivable as security. The same general type of financing vehicle is available to exporters to finance their foreign receivables.

A common method of financing foreign receivables is through the exporter pledging all outward collections to its bank. The exporter may then borrow from the bank up to a stated maximum percentage of the total amount of receivables pledged at any one time. When notes rather than drafts are used to finance foreign receivables, they are usually paid on demand, enabling the exporter to increase or decrease the loan depending on its needs and the current amount of collections outstanding. Preferably, all of the collections lodged with the exporter's bank should be pledged to the bank. When a particular collection is paid, it is remitted by a foreign collecting bank to the exporter's bank, which has already advanced the funds to the exporter. The exporter's bank then uses the proceeds of the collection to reduce the exporter's loan.

Some exporters have no need for a continuous financing arrangement but occasionally may wish to obtain financing on only one large foreign receivable. In these instances, the exporter's bank may be willing to advance funds to the exporter with only that one receivable as security. Again, the bank establishes a maximum percentage of the amount of the receivable that it is willing to advance. When payment for the receivable is obtained, the bank uses the proceeds to liquidate the loan, crediting any excess to the exporter. Bank financing in the form of advances against export receivables is an accepted practice in international trade and is not considered factoring.

Besides having a lien on the exporter's outward collections, the bank usually retains recourse to the exporter, whose credit strength and reputation are of prime importance. Other factors, however, are also significant. If the foreign importers are companies with strong

reputations and financial strength, the bank will likely advance a larger percentage on collections directed to them. The bank will also likely advance a larger percentage of funds to importers in those countries in which importers promptly pay drafts drawn on them. In other countries where payment is generally slow, perhaps because importers are financially weak or because U.S. dollar or other foreign-currency exchange is hard to obtain, the bank will advance a lower percentage on collections. The exporter's bank may be completely unwilling to finance collections directed to importers or countries with reputations for habitually slow payments.

When a bank advances against foreign receivables, it must carefully scrutinize the supporting documents. Since the bank wishes to maintain control of the merchandise, the bill of lading should be either "to the order of" the shipper and blank-endorsed or "to the order of" the bank. The bill of lading must not be consigned to the buyer (importer) since this gives the buyer control over the goods. Also, financed shipments should be covered by adequate insurance.

DISCOUNTING TRADE ACCEPTANCES

A draft accepted by the foreign importer becomes a trade acceptance carrying the full credit obligation of the importer. These trade acceptances are also frequently called "trade bills" or "trade paper." The acceptance is returned to and becomes the property of the exporter, who will ask the collecting bank to present it to the importer or acceptor for payment at maturity. The exporter is, therefore, providing the financing or "carrying" its own foreign receivables. However, if the exporter needs the funds before maturity of the trade acceptance, the exporter may ask the bank to "discount" the draft. If the primary obligor (the acceptor) is a well-known company of good credit standing, the bank may be willing to discount the draft without recourse to the exporter. More commonly, however, the lending bank looks to the exporter for recourse should the primary obligor fail to pay the amount when due.

When discounting a trade acceptance, the bank applies a discount to the face amount of the draft and advances the remainder to the exporter until the draft's maturity. The bank is "buying" the trade acceptance for value and is entitled to

any benefits from the primary obligor to which it is due as a holder in due course of a negotiable instrument. This is also the case whenever the bank advances against a single collection or a pool of collections. Any intermediary “collecting” bank also has a financial interest in the collection and has all the rights of a holder in due course under the Uniform Commercial Code.

BANKER’S ACCEPTANCES CREATED AGAINST FOREIGN COLLECTIONS

During periods of tight money, banks may choose to finance foreign collections by using banker’s acceptances. Banker’s acceptances are discussed in section 7060, “International—Banker’s Acceptances,” so the following comments relate only to the financing of foreign collections.

As with all acceptance financing, the exporter first submits a signed acceptance agreement to its bank. To obtain acceptance financing for foreign receivables, the exporter draws two drafts. The first is a time draft drawn on the foreign buyer (the importer) that, along with the necessary documents, is sent for collection in the usual manner. The second draft, for the same or a smaller amount as agreed to by the bank and the exporter, is drawn by the exporter on its bank and has the same tenor as the draft drawn on the importer. The bank accepts the second draft and discounts it, crediting the net amount to the exporter’s account. The bank has now created a banker’s acceptance that can be sold in the highly liquid acceptance market, provided the bank’s reputation is solid. When payment is received from the importer, the bank applies the proceeds towards its own acceptance, which will be presented for payment if sold in the market. Should the drawee default, the bank has recourse to the drawer and can demand payment from that source.

FORFAITING

Forfaiting is basically nonrecourse financing of receivables, similar to factoring. However, although a factor normally purchases a company’s short-term receivables, a forfait bank purchases notes that are long-term receivables with maximum maturities of eight years. The forfaiting bank has no recourse to the seller of the

goods, but gets the notes at a substantial discount in exchange for cash. Zurich and Vienna are the centers of forfaiting. Many large banks, including U.S. institutions, provide forfaiting through either their branches or specialized subsidiaries in these cities.

Forfaiting is used when government export credits or credit guarantees are not available or when a seller does not extend long-term credits to areas such as Eastern Europe. Forfaiting is also an important method of financing for small and medium-sized companies because it enables them to engage in transactions that would normally exceed their financial capabilities. By using forfaiting, small and medium-sized concerns can immediately sell their long-term receivables without recourse.

Forfaiting presents all of the risks associated with factoring, along with the risks associated with the long-term nature of purchased receivables. The examiner should review the bank’s forfaiting activities carefully to determine whether long-term receivables have been purchased from countries prone to periodic political or economic turmoil and the resulting fluctuations in exchange rates.

U.S. AND FOREIGN RECEIVABLES GUARANTEE AND INSURANCE PLANS

To reduce credit, political, and other risks associated with foreign receivables financing, banks may avail themselves of a variety of guarantee and insurance plans, both public and private, that are available in many countries. Because of the complexity of the numerous plans available, an examiner must frequently rely on the technical knowledge of the staff in a bank’s international division who handle these transactions. Nevertheless, the examiner should know the risk coverage and claim adjustment provisions of the major plans. Often a bank’s experience with its receivables insurance and guarantee plans is indicative of its effectiveness and of whether the bank has properly met its responsibilities under the programs.

Export-Import Bank of the United States

The Export-Import Bank of the United States (Eximbank) issues to commercial banks, for a

fee, guarantees of payment for foreign receivables that the bank purchases from exporters, generally without recourse to the exporter. The maturities of the receivables range from 181 days to over five years. Generally, the foreign buyer must make a cash payment, either before or upon delivery, of at least 10 percent of the invoice value, and the amount of receivables purchased by the bank without recourse to the exporter normally cannot exceed 90 percent of the financed portion of the sale (invoice amount less cash payment). This guarantee covers political risks, such as inconvertibility of foreign currencies into U.S. dollars, governmental actions preventing importation of goods, war, civil strife, expropriation, and confiscation by government action. Commercial risks, basically the credit risk of the foreign purchaser, usually are covered from six months to five years.

Foreign Credit Insurance Association

The Foreign Credit Insurance Association (FCIA) is an association of leading marine, property, and casualty insurance companies. In cooperation with Eximbank, FCIA offers a comprehensive selection of credit insurance policies that protect policyholders against loss from failure to receive payment from foreign buyers.

FCIA coverage protects the exporter against the failure of the buyer to pay dollar obligations for commercial or political reasons; enables the exporter to offer foreign buyers competitive terms of payment; supports the exporter's prudent penetration of higher risk foreign markets; and gives the exporter greater liquidity and flexibility in administering a foreign receivables portfolio. The FCIA does not itself finance export sales. However, the exporter who insures account receivables against commercial and political risks is usually able to obtain financing from commercial banks and other lending institutions at lower rates and on more liberal terms than would otherwise be possible by assigning the proceeds of the FCIA insurance to the lenders.

Comprehensive FCIA policies protect exporters against nonpayment of receivables due to unforeseeable commercial and political occurrences. Commercial risks covered include insolvency or protracted default, which may be caused by economic deterioration in the buyer's market area, shifts in demand, unanticipated

competition, tariffs, or technical changes. Political risk coverage applies to defaults due to government action, such as currency inconvertibility, expropriation, and cancellation of import license, and to political disturbances, such as war, revolution, and insurrection.

FCIA generally offers four basic types of policies covering political and commercial risks:

- Short-term policies covering shipments normally sold on terms up to 180 days. The usual policy covers 100 percent of political risks and 90 percent of any losses from commercial risk.
- Medium-term policies insuring transactions from six months to five years. FCIA covers up to 100 percent of political risks and 90 percent of commercial risks, with the remainder retained by the exporter.
- Combined short-term/medium-term policies for sales that pass through distributors before reaching final buyers.
- Master policies that include the basic insurance features of the previous policies plus discretionary and deductible provisions. Under a master policy, usually only for short-term transactions, exporters may obtain FCIA authority to grant insured credit up to a certain amount without seeking prior approval. The deductible provision, used only for commercial risks and not political risks, requires the exporter to assume a fixed amount of the first loss on total debts.

(Source: *Washington Agencies That Help to Finance Foreign Trade*, seventh edition, Bankers Trust Company, New York.)

Other Insurers

Numerous other private and governmental institutions, both in the United States and overseas, guarantee or insure risks assumed by commercial banks financing foreign receivables. Some examples of these institutions in other countries are the Export Credits Guarantee Department (ECGD) in the United Kingdom, COFACE in France, and HERMES in Germany.

In the United States, the Overseas Private Investment Corporation (OPIC), a corporation wholly owned by the U.S. government, offers insurance against the political risks of inconvertibility, expropriation, war, revolution, and insur-

rection and guarantees the repayment of private U.S. loans for U.S. citizens, U.S. concerns that are substantially and beneficially U.S.-owned,

and foreign concerns that are at least 95 percent owned by U.S. individuals or entities.

International—Financing Foreign Receivables

Examination Objectives

Effective date May 1996

Section 7050.2

1. To determine if the policies, practices, procedures, and internal controls for the financing of foreign receivables are adequate.
2. To determine if bank officers are operating in conformance with established bank guidelines.
3. To evaluate the portfolio for credit quality, collectibility, and collateral sufficiency.
4. To determine the scope and adequacy of the audit function as it relates to the financing of foreign receivables.
5. To determine compliance with laws and regulations.
6. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws and regulations are cited.

International—Financing Foreign Receivables

Examination Procedures

Effective date June 1985

Section 7050.3

1. If selected for implementation, complete or update the International—Financing Foreign Receivables section of the International Control Questionnaire.
2. Determine the scope of the examination based on the evaluation of internal controls and the work performed by internal and external auditors.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest reviews done by internal and external auditors from the examiner assigned to the audit review and determine if appropriate corrections have been made.
4. Obtain trial balances of applicable customer liability records and:
 - a. Reconcile balances to department controls and the general ledger.
 - b. Review reconciling items for reasonableness.
5. Using an appropriate technique, select borrowers for examination.
6. Prepare examiners' credit line cards to include:
 - a. Customers' aggregate foreign receivables financing liability.
 - b. Debt instruments aggregating customers' total outstanding liability.
7. Obtain the following information:
 - a. Past-due, nonaccrual and reduced rate loans, advances, and acceptances.
 - b. Loans whose terms have been modified by a reduction in the interest rate or the principal payment or by a deferral of interest or principal.
 - c. Loans transferred, either in whole or in part, to another lending institution as a result of a sale, participation or asset swap, since the previous examination.
 - d. Loans acquired from another lending institution as a result of a purchase, participation or asset swap, since the previous examination.
 - e. Loan commitments and other contingent liabilities.
 - f. Loans to principal shareholders, officers, and directors, and to their interests (indicate which officers are considered executive officers).
8. Review the information received and perform the following for:
 - a. Loans transferred, either in whole or in part, to or from another lending institution as a result of a participation, sale/purchase, or asset swap. Perform procedures in step 7a of the section on International—Loans and Current Account Advances, Examination Procedures.
 - b. Miscellaneous loan debit and credit suspense accounts:
 - Discuss with management any large or old items.
 - Perform additional procedures as considered appropriate.
 - c. Loan commitments and other contingent liabilities:
 - g. Loans to executive officers, directors, and principal shareholders, and their interests, of correspondent banks.
 - h. A list of correspondent banks.
 - i. Miscellaneous loan debit and credit suspense accounts.
 - j. Interagency Country Exposure Review Committee determinations.
 - k. Criticized shared national credits (applicable international credits).
 - l. Loans considered as "problem loans" by management.
 - m. Background information on directors, executive officers, principal shareholders, and their interests.
 - n. Specific guidelines in the lending policy governing the financing of foreign receivables.
 - o. Current lending authorities of officers and lending committee(s).
 - p. The current interest rate structure.
 - q. Any useful information obtained from the review of the minutes of the loan and discount committee or any similar committee.
 - r. Reports furnished to the loan and discount committee(s) or any similar committee(s).
 - s. Relevant reports furnished to the board of directors.
 - t. Loans classified during the previous examination.

- Analyze the commitments and contingent liabilities of the obligors together with the combined amounts of their current loan balances.
- d. Loans criticized during the previous examination:
 - Determine disposition of loans so classified by transcribing:
 - Current balance and payment status, or
 - Date the loan was repaid and the source of repayment.
 - Investigate any situations where all or part of the funds for the repayment came from the proceeds of another loan at the bank, or as a result of a participation, sale or swap with another lending institution.
 - If repayment was a result of a participation, sale or swap, refer to step 7a of the International—Loans and Current Account Balances, Examination Procedures section for the appropriate examination procedures.
- e. Shared national credits:
 - Compare the schedule of foreign receivables financed included in the Uniform Review of National Credits program to the listing of credits selected for review to determine which loans in the sample are portions of shared national credits.
 - For each loan so identified, transcribe appropriate information from the schedule to line cards. No further examination procedures are necessary in this area.
- f. Interagency Country Exposure Review Committee credits:
 - Identify any credits that were selected for review that are criticized for transfer risk reasons by the Interagency Country Exposure Review Committee.
- 9. Transcribe or compare information from the above schedules to credit line cards, where appropriate, and indicate any past-due status.
- 10. Prepare credit line cards for any loan not in the sample which, based on information derived from the above schedules, requires an in-depth review.
- 11. Obtain liability and other information on common borrowers from examiners assigned to international cash accounts, overdrafts, and other loan areas and together, decide who will review the borrowing relationship. Pass or retain completed credit line cards.
- 12. Prepare collateral line cards for all borrowers selected in the preceding steps.
- 13. Obtain credit files for all borrowers for whom examiner credit line cards were prepared and complete credit line cards, where appropriate. To analyze foreign receivables financed, perform the following procedures:
 - a. Analyze the customers' balance sheets and profit and loss figures as shown in current and preceding financial statements and determine the existence of any favorable or adverse trends.
 - b. Review components of the balance sheet as shown in the current financial statements and determine the reasonableness of each item as it relates to the total financial structure.
 - c. Review supporting information for the major balance sheet items and the techniques used in consolidation and determine the primary sources of repayment and evaluate their adequacy.
 - d. Determine compliance with provisions of loan agreements.
 - e. Review digest of officers' memoranda, mercantile reports, credit checks, and correspondence to determine the existence of any problems which might deter the contractual repayment program.
 - f. Obtain the following information for:
 - Open Account Financing:
 - Whether the shipment is directed to third parties or branches and subsidiaries of the borrower.
 - The financial strength and trustworthiness of the overseas buyer.
 - The extent of foreign exchange control and the availability of exchange for the importer to effect payment.
 - The bank's past experience in dealing with the borrower who sells on open account.
 - Sales on Consignment:
 - Whether the shipment is directed to third parties or branches and subsidiaries of the obligor.
 - The financial strength and trustworthiness of the foreign consignee.

- The responsibilities of the foreign sales agent, overseas representative, or import house under contract.
- The extent of foreign exchange control and the availability of exchange for that type of transaction in the country of destination.
- Whether the borrower's goods, without a definite buyer, are consigned abroad in the name of the borrower's bank or a foreign bank.
- Whether the goods being shipped are assigned to a responsible warehouseman.
- Any arrangements that have been made whereby the selling agent negotiates for the sale of the goods.
- The regulations in the country of destination regarding the return of unsold consigned goods to the country of origin.
- The bank's past experience in dealing with the borrower who sells on consignment.
- **Advances Against Collections:**
 - The relationship between the amount collected in a month on the collections pledged as collateral and the borrower's credit limit.
 - The tenor of sight drafts—a stated number of days after sight or a stated number of days after the date of the draft.
 - Instructions regarding delivery of documents against payment (D/P) or documents against acceptance (D/A).
 - Whether amounts advanced against collections are within the percentage of advance limitation established.
 - Aging of drafts (collections).
 - Ineligible drawees, including house bills.
 - Concentrations of drawees.
 - Financial strength of drawees.
 - Unusual situations such as disputes, nonacceptance of goods, and possession of goods without payment.
 - Dishonor and protest instructions.
 - Any special instructions.
 - The extent of foreign exchange controls and the availability of exchange for that type of transaction in the country of destination.
- **Discounted Trade Acceptances:**
 - The bank's experience in dealing with the borrower who receives advances against collections.
 - The relationship between the amount collected in a month on the trade acceptances discounted and the borrower's credit limit.
 - Whether the bank discounted the trade acceptance with or without recourse.
 - Whether the borrower retains a percentage of the trade acceptance endorsed to the bank.
 - Aging of trade acceptances.
 - Ineligible drawees, including house bills.
 - Concentrations of drawees.
 - Financial strength of the drawees.
 - Unusual situations, such as disputes, nonacceptance of goods, and possession of goods without payment.
 - Dishonor and protest instructions.
 - Any special instructions.
 - The extent of foreign exchange controls and the availability of exchange for that type of transaction in the country of destination.
- **Banker's Acceptance Financing:**
 - The relationship between the amount collected from the foreign buyer in a month and the borrower's credit limit.
 - Whether the discounted draft drawn by the exporter (customer) on the exporter's bank has the same tenor as the draft addressed to the foreign buyer.
 - The procedures for applying payment received from the foreign buyer to pay the bank's own acceptance.
 - Aging of time drafts drawn on the importer (drawee).
 - Ineligible foreign buyers (drawees), including house bills.
 - Concentrations of foreign buyers (drawees).

- Financial strength of the foreign buyers (drawees).
- Disputes, nonacceptance of goods, and possession of goods without payment.
- Dishonor and protest instructions.
- Any special instructions.
- The extent of foreign exchange control and the availability of exchange for that type of transaction in the country of destination.
- The bank's experience in dealing with the borrower.
- Factoring:
 - The extent the factor "guarantees" letters of credit opened by the bank in favor of overseas suppliers.
 - Whether the title documents on import transactions are consigned to or endorsed over to the factor.
 - Whether the importer who receives goods under trust receipt agrees to hold them in trust for the factor.
 - Whether the imported goods held under warehouse receipt are stored in an independent warehouse for the account of the factor.
 - Whether usance letters of credit are paid to the bank by the factor at maturity, and the resulting acceptances are charged to the bank customer's account for payment to the factor when due.
 - Whether the factor borrows from the bank or creates a banker's acceptance pending payment of accounts receivable resulting from the sale of goods imported under letters of credit.
 - The financial strength of the importer for whom the bank opened the letter of credit.
 - Any disputes, nonacceptance of goods, and possession of goods without payment.
 - The bank's experience in dealing with the factor.
- Forfaiting:
 - Agings of debtor accounts purchased.
 - Ineligible debtor accounts purchased, including affiliate receivables, if any.
 - Concentration of debtor accounts purchased.
- The adequacy of the bank's credit investigation before approving the sale (or signing of a sales contract) creating a receivable.
- The financial strength of the debtor accounts purchased.
- The capability of the exporter from whom receivables were purchased to provide any required after-sales service and to honor warranties.
- Disputes and returns.
- The extent of foreign exchange restrictions, availability of exchange, and country risk involved that could jeopardize collection of receivables purchased.
- The bank's experience in dealing with both the debtors and the exporter.
- U.S. and Foreign Receivables Guarantee and Insurance Plans:
 - Whether foreign receivables coverage by FCIA, Eximbank, or other insurance or guarantee programs is sufficient, adequately identifies risks, and is consistent with established limits.
- g. Analyze secondary support offered by guarantors and endorsers.
- h. Determine compliance with the bank's established international loan policy.
- 14. For loans in the sample, check the central liability file on borrowers indebted above the cut-off line or borrowers displaying credit weaknesses or suspected of having additional liability in other loan areas.
- 15. Transcribe significant liability and other information of officers, principals, and affiliations of appropriate borrowers contained in the sample. Cross-reference line cards to borrowers, where appropriate.
- 16. Determine compliance with laws and regulations pertaining to financing foreign receivables by performing the following steps for:
 - a. *Lending limits*:
 - Determine the bank's lending limit as prescribed by state law, and note any exceptions.
 - b. *Section 23A, Federal Reserve Act (12 USC 371c)—Transactions with Affiliates*:
 - Perform procedures in step 15b of International—Loans and Current

- Account Advances, Examination Procedures section.
- c. *18 USC 215—Commission or Gift for Procuring Credit Extensions:*
 - While examining foreign receivables financing, determine the existence of any possible cases in which a bank officer, director, employee, agent, or attorney may have received anything of value for procuring or endeavoring to procure any extension of credit.
 - Investigate any such suspected irregularities.
 - d. *Federal Election Campaign Act (2 USC 441b)—Political Contributions:*
 - Determine the existence of any loans in connection with any political campaigns.
 - Review each such credit to determine whether it is made in accordance with applicable banking laws and in the ordinary course of business.
 - e. *12 USC 1972 and Regulation Y (12 CFR 225.4(d))—Tie-In Provisions:*
 - Determine whether any credit extension is conditioned upon:
 - Obtaining or providing any additional credit, property, or service from or to the bank or its holding company other than a loan, discount, deposit, or trust service.
 - The customer not obtaining a credit, property, or service from a competitor of the bank or its holding company (or a subsidiary of its holding company), other than a reasonable condition to assure the soundness of the credit.
 - f. *Regulation O (12 CFR 215)—Loans to Executive Officers, Directors, Principal Shareholders, and Their Interests; and Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (12 USC 1972(2))—Loans to Executive Officers, Directors and Principal Shareholders of Correspondent Banks:*
 - Perform procedures in step 15f of International—Loans and Current Account Advances, Examination Procedures section.
 - g. *The Financial Recordkeeping and Reporting of Currency and Foreign Transactions (31 CFR 103)—Retention of Credit Files:*
 - Review the operating procedures and credit file documentation and determine if the bank retains records of each extension of credit over \$5,000, specifying the name and address of the borrower, the amount of the credit, the nature and purpose of the loan, and the date thereof. (Loans secured by an interest in real property are exempt.)
 17. Perform appropriate procedural steps in the Concentrations of Credit section.
 18. Discuss with appropriate officers and prepare summaries in appropriate report form of:
 - a. Delinquent loans, segregating those considered “A” paper.
 - b. Loans not supported by current and complete financial information.
 - c. Loans on which documentation is deficient.
 - d. Loans with credit weaknesses.
 - e. Inadequately collateralized loans.
 - f. Criticized loans, including supporting commentaries.
 - g. Concentrations of credit.
 - h. Extensions of credit to major shareholders, officers and directors, and to their related interests.
 - i. Violations of laws and regulations.
 - j. Other matters regarding the condition of the department.
 19. Evaluate the bank with respect to:
 - a. The adequacy of written policies relating to financing foreign receivables.
 - b. The manner in which bank officers are operating in conformance with established policy.
 - c. Adverse trends in those sections of the international sector of the bank concerned with financing foreign receivables.
 - d. The accuracy and completeness of the schedules obtained from International—Loan Portfolio Management.
 - e. Recommended corrective action when policies, practices, or procedures are deficient.
 - f. The competency of departmental management.
 - g. Other matters of significance.
 20. Update the workpapers with any information that will facilitate future examinations.

International—Financing Foreign Receivables

Internal Control Questionnaire

Effective date March 1984

Section 7050.4

Review the bank's internal controls, policies, practices, and procedures regarding foreign receivables financing. The bank's system should be documented in a complete and concise manner and include, where appropriate, narrative descriptions, flowcharts, copies of forms used, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written foreign receivables financing policies that:
 - a. Establish procedures for reviewing financing applications?
 - b. Establish standards for determining credit lines?
 - c. Establish standards for determining the percentage of advances made against acceptable collections (receivables)?
 - d. Define acceptable receivables (collections)?
 - e. Establish minimum requirements for verification of borrower's receivables (collections)?
 - f. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
 2. Are foreign receivables financing policies reviewed at least annually to determine if they are compatible with changing market conditions?
5. Are inquiries regarding foreign receivables financing loan balances received and investigated by persons who do not normally process documents, handle settlements, or post records?
 - *6. Are bookkeeping adjustments checked and approved by an appropriate officer?
 - *7. Is a daily record maintained summarizing transaction details, i.e., loans made, payments received, and interest collected to support applicable general ledger entries?
 - *8. Are frequent debt instrument and liability ledger trial balances prepared and reconciled monthly with control accounts by employees who do not process or record loan transactions?

DOCUMENTATION

9. Are terms, dates, weights, description of the merchandise, etc., shown on invoices, shipping documents, trust receipts, and bills of lading scrutinized for differences?
10. Are procedures in effect to determine if the signatures shown on the above documents are authentic?
11. Are payments received from customers scrutinized for differences in invoice dates, numbers, terms, etc.?

LOAN INTEREST

- *12. Is the preparation and posting of loan interest records performed or adequately reviewed by persons who do not also:
 - a. Issue official checks or drafts?
 - b. Handle cash?
13. Are independent interest computations made and compared or adequately tested to initial loan interest records by persons who do not also:
 - a. Issue official checks or drafts?
 - b. Handle cash?

COLLATERAL

- *14. Does the bank record on a timely basis a first lien on assigned foreign receivables for each borrower?

ACCOUNTING RECORDS

- *3. Is the preparation and posting of subsidiary records performed or adequately reviewed by persons who do not also:
 - a. Issue official checks or drafts?
 - b. Handle cash?
- *4. Are subsidiary records reconciled, at least monthly, with the appropriate general ledger accounts and reconciling items adequately investigated by persons who do not normally handle foreign receivables financing?

15. Do loans granted on the security of the foreign receivables also have an assignment of the inventory?
16. Does the bank verify the borrower's receivables or require independent verification on a periodic basis?
17. Does the bank require the borrower to provide aged receivables schedules on a periodic basis?
18. Are underlying bills of lading covering shipments either to the order of the shipper or blank endorsed to the order of the bank rather than the foreign buyer?
19. Are the shipments being financed covered by adequate insurance?
20. Are U.S. banks forwarded directly to the bank and not through the exporter?
30. If the exporter accepts importer (drawee) payments directly, are controls established or audits of exporter's books conducted (if so, explain briefly)?
31. Are employees handling collections periodically rotated, without advance notification, to other banking duties?
- *32. Is the employee handling collection proceeds required to apply them to the borrower's advance on the same business day that payment is received?
33. Is the disposition of each collection noted on the register so that verification of disposition can be made?
- *34. Has a regular policy of following procedures been established for sending tracers and inquiries on unpaid collections in the hands of correspondents?
- *35. Should the foreign drawee refuse to honor the draft, are instructions clear as to what actions should be taken by the collecting bank?
36. In the event of non-payment of the collection, is the borrower promptly notified by the bank?
- *37. Are collections against which advances have been made or trade acceptances discounted distinctly segregated from ordinary collection items?
- *38. Are collections above maintained under memorandum control and is the control balanced regularly?
- *39. Are collections against which advances have been made or trade acceptances discounted booked by persons other than employees handling those items?
- *40. Are collections carried over to the next business day adequately secured?
41. Does the customer for whom trade acceptances were discounted know whether they were purchased with or without recourse to that customer?
- *42. Do all parties, i.e., the seller (exporter), importer (buyer), and banks, clearly understand whether interest, discount, and collection charges are to be absorbed by the seller or paid by the importer?

ADVANCES AGAINST COLLECTIONS AND DISCOUNTED TRADE ACCEPTANCES

20. Are permanent registers kept for foreign collections against which advances were made or trade acceptances discounted?
21. Are all collections indexed in a collection register?
22. Do these registers furnish a complete history of the origin and final disposition of each collection against which advances were made or trade acceptances discounted?
23. Are receipts issued to loan customers for all collections received from them?
24. Are serial numbers or prenumbered forms assigned to each collection item and all related papers?
- *25. Are all incoming tracers and inquiries handled by an officer or employee not connected with the processing of collections?
26. Is a daily record maintained showing the various collections which have been paid and credited to the borrower's advance?
- *27. Are proceeds of paid collections credited to the correct customer's advance?
28. Is an itemized daily summary made of all interest charged and received from the exporter or importer (drawee) indicating underlying collection numbers and amounts?
29. Are payments collected from importers (drawees) by foreign banks or branches of

FACTORING

43. Has the bank properly surrendered the

- shipping documents to the factor either through endorsement or consignment?
- *44. Do bank advances or banker's acceptances to the factor in payment of sight or time draft coincide with the expected payment of the accounts receivable by the ultimate customer?

FOREIGN CREDIT INSURANCE ASSOCIATION INSURANCE

45. Is the bank aware of risks not covered under its FCIA insurance?
46. Does the bank monitor whether the borrower exceeded its FCIA established credit limits?
47. Does the bank monitor whether the borrower properly assigned the proceeds of its FCIA insurance to the bank?
48. Is the bank aware whether the FCIA insurance is on either "simple notice" or a "special assignment" basis?
49. Does the bank retain recourse to the exporter under its FCIA arrangement?
50. Has the bank reported delinquencies to FCIA in accordance with its agreement with the Association?
51. If default occurs, does the bank file a proper claim with FCIA?

EXPORT-IMPORT BANK OF THE UNITED STATES

52. Does the bank, financing under Eximbank arrangements, have properly executed

Eximbank guarantees or commitments covering transactions?

53. If the bank has discretionary authority from Eximbank, does it nevertheless inform Eximbank of each transaction thereunder?
54. If the bank has been issued an "equipment political risk guarantee" by Eximbank, does it have a written statement from the government of the country in which the equipment will be used indicating that it will permit the importation, use, and any subsequent exportation of the equipment?
55. Does the bank monitor whether loan agreements between applicable borrowers and the bank are acceptable to Eximbank?
56. Does the bank report delinquencies to Eximbank in a timely manner as specified in its agreement with that agency?
57. If default occurs, does the bank file a proper claim with Eximbank?

CONCLUSION

58. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
59. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).